Supreme Court, U. S.
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IN THE

Supreme Court of the United States

OCTOBER TERM, 1979

No. 79-79-155

POTOMAC ELECTRIC POWER COMPANY,
Petitioner,

v.

PUBLIC SERVICE COMMISSION OF THE DISTRICT OF COLUMBIA,

WASHINGTON PUBLIC INTEREST ORGANIZATION,
Respondents.

PETITION FOR A WRIT OF CERTIORARI TO THE DISTRICT OF COLUMBIA COURT OF APPEALS

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Washington, D.C.
July 30, 1979

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CERTIFICATE OF SERVICE

I hereby certify that I have this 30th day of July, 1979 served a copy of this Petition for a Writ of Certiorari to the District of Columbia Court of Appeals, by mailing three copies thereof, together with a copy of this certificate of service, postage prepaid, to counsel for all parties of record, as follows:

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Respondents.

PETITION FOR A WRIT OF CERTIORARI TO THE DISTRICT OF COLUMBIA COURT OF APPEALS

Petitioner, Potomac Electric Power Company (Pepco), respectfully prays that a writ of certiorari issue to review the opinion and judgment of the District of Columbia Court of Appeals in Docket No. 12017, entered on September 12, 1978, which reversed and remanded the final decision of the Public Service Commission of the District of Columbia issued on December 16, 1976.

OPINIONS BELOW

The opinion of the District of Columbia Court of Appeals, issued on September 12, 1978 in Docket No. 12017, *et al.*, is reported at 393 A.2d 71 and is reprinted *infra* at Appendix D. That opinion remanded

the following orders of the District of Columbia Public Service Commission (Commission) issued in Formal Case No. 651: (1) the Commission's Proposed Opinion and Order No. 5831 issued October 20, 1976, which is not reported and is reprinted *infra* at Appendix A (as amended by Errata Order No. 5832, also issued October 20, 1976), and (2) the Commission's Opinion and Order No. 5849, issued December 16, 1976 which is not reported and is reprinted *infra* at Appendix B. Also, the Commission's "Order on Reconsideration", Order No. 5856 issued February 14, 1977, is not reported and is reprinted *infra* at Appendix C.

The Court of Appeals' unreported Order issued November 2, 1978 regarding rehearing *en banc,* is reprinted *infra* at Appendix E, and the Court's unreported Order denying Pepco's petition for rehearing or rehearing *en banc,* issued May 3, 1979, is reprinted at Appendix F. The "Separate Dissenting Statement" filed by Associate Judge Nebeker on July 17, 1979 is not yet reported and is reprinted *infra* at Appendix G.

JURISDICTION

The order of the District of Columbia Court of Appeals denying a timely petition for rehearing or rehearing *en banc* was entered on May 3, 1979. This petition for a writ of certiorari was filed within ninety days of that date, and the jurisdiction of this Court is invoked under 28 U.S.C. § 1257(3) (1976).

QUESTIONS PRESENTED

Each question concerns a private investor-owned corporation (Pepco) which, *inter alia,* provides utility

services in several States and the District of Columbia, and is subject to separate utility rate regulation in each State and in the District of Columbia with respect to its utility operations:

1. If the Commission reduces utility rates by subtracting the corporation's gains on the sale of *non-utility* property, does it take the corporation's property in violation of the due process and just compensation clauses of the Fifth Amendment?

2. If the Commission reduces utility rates for prospective application by subtracting the corporation's gains on the sale of *non-utility* property received over a prior ten year period, does it indulge in retroactive ratemaking in violation of the due process and just compensation clauses of the Fifth Amendment?

3. If the Commission reduces utility rates under its jurisdiction by reflecting income from non-jurisdictional business, does it take the corporation's property in violation of the due process and just compensation clauses of the Fifth Amendment?

CONSTITUTIONAL PROVISIONS INVOLVED

The due process and just compensation clauses of the Fifth Amendment to the Constitution of the United States:

> No person shall be . . . deprived of life, liberty, or property, without due process of law; nor shall private property be taken for public use, without just compensation.

STATEMENT OF THE CASE

The facts were stipulated. During the 10 year period of 1965 to 1974, Pepco sold, or transferred to non-util-

ity status pending sale, property of two kinds which had formerly been used in utility operations but which were no longer used or useful in providing utility service:

(1) several small parcels of land; and

(2) a former office building (finally sold in 1976).

These produced a net *gain* on all the parcels of land (total sale price exceeded total book value), and a net *loss* on the office building (sale price was less than the *depreciated* book value of the structure).

In late 1975, Pepco applied to the District of Columbia Public Service Commission for a general rate increase. The Commission's final order, issued December 16, 1976, granted part of the requested increase based on a "test period" consisting of calendar year 1975. In other words, the Commission analyzed Pepco's utility operations and costs for the year 1975 to see if the rate of return earned was adequate, or if inadequate, by how much.

In the course of its analysis of Pepco's 1975 operations, the Commission did not examine sales of land (or any other events) which took place prior to 1975, or the sale of the office building which took place in 1976. Nevertheless, one party [1] protested the proposed rate increase to the extent that the Commission refused to give the net proceeds of these sales of non-utility property to Pepco's utility customers.

The Commission rejected WPIO's position three times: in its Proposed Opinion and Order (Appendix A at 34-36); in its Final Opinion and Order (Appendix B at 19-20); and in its Order on Reconsideration

[1] Washington Public Interest Organization (WPIO).

(Appendix C at 3). Each time, the Commission approved Pepco's accounting treatment of these gains generally and rejected WPIO's thesis that Pepco's utility customers were entitled to receive the proceeds of Pepco's non-utility, non-jurisdictional transactions.

The Commission's decision with respect to this issue was appealed by WPIO, and a three-judge panel of the District of Columbia Court of Appeals decided, on September 12, 1978, *sua sponte,* that the Commission must consider, in this and future cases, "the impact of non-utility transactions on the price of the company's stock" as a factor in calculating the authorized *utility* rate of return (Appendix D at 48d). The constitutional argument—which Pepco had raised from the outset of the proceedings below—that its shareholders were entitled to these net gains from non-utility transactions as a matter of law, was totally ignored.

The dissenting member of the panel stated that the majority had created a "non-issue" that "should not have been raised" by the Court, and once raised, had been "erroneously resolved." (Appendix G at 12g, 14g)

Pepco filed a timely petition for rehearing or rehearing *en banc* of the Court of Appeals' decision on October 10, 1978. In that Petition, Pepco in summary reiterated that,

> As its fundamental proposition before the Commission and the Court, Pepco challenged [the authority of the Commission to act as sought by WPIO] on Constitutional and legal grounds. Three such grounds exist, each of which the Court has failed to address:
>
> 1. That giving ratepayers the gains on sales of former utility property is a confiscation of the shareholder's interest in that property.

2. That giving present Pepco ratepayers the gains on the sales of the property at issue would constitute retroactive ratemaking, in contravention of the finality of prior Commission ratemaking orders.

3. That the holding of the Court would require the Commission unconstitutionally to consider non-jurisdictional revenue in fixing rates for jurisdictional utility operations.

Specifically, Pepco again raised this Court's decision (totally ignored by the panel of the Court of Appeals) in *Board of Public Utility Comm'rs* v. *New York Tel. Co.*, 271 U.S. 23 (1926), as being dispositive of the issues of substantive due process and confiscation of property without just compensation.

On rehearing *en banc*, the Court of Appeals ordered the other respondents to comment on Pepco's argument that the relief sought by WPIO was constitutionally barred, addressing themselves "particularly to the continuing validity of *Board of Public Utility Comm'ers, supra.*" (Appendix E). Subsequently, on May 3, 1979, rehearing and rehearing *en banc* were both denied (Appendix F) with two dissents, one of which was explained in the "Separate Dissenting Statement" of Judge Nebeker. (Appendix G, filed on July 17, 1979)[2]

[2] Judge Nebeker's dissenting views were withheld at the time the majority released its opinion, due to the interrelationship between certain aspects of this case and the appeal in Docket No. 10490, still pending at that time and involving some of the same parties, which is the subject of a separate Petition for Writ of Certiorari concurrently filed by Pepco in this Court.

REASONS FOR GRANTING THE WRIT

I. Reducing Otherwise Just And Reasonable Utility Rates Because Of Gains Realized From The Sale Of Non-Utility Property Results In The Confiscation Of Pepco's Property Without Substantive Due Process And Without Just Compensation

This appeal concerns the fundamental constitutional rules governing private investment in an essential enterprise which serves the public. The Court of Appeals decision (which reversed and remanded the Commission's decision below) ignores these rules, with an unconstitutional result. The practical effect of the decision is to deter investment in public utilities, directly increasing the cost of providing utility service and, thus, the rates charged to the public.

This broad issue is of immediate national concern. In recent months, the devastating nuclear reactor accident at Three Mile Island Unit No. 2 electric generating station in Pennsylvania, has focused public attention on the respective obligations of utility investors and utility customers to bear the risk of loss in providing utility service.

In this proceeding, the Court of Appeals addressed the converse: what to do with the gains and losses realized on the sale of non-utility property. The underlying issue is the same, however, for the risk of loss accompanies the opportunity for gain. The essential distinction is between *ownership* of an asset by utility shareholders and *use* of the asset to provide service to utility customers. Shareholders own the assets and bear the risk of loss as well as the possibility of gain on their property.

In its opinion, the Court of Appeals states that Pepco must be afforded a reasonable opportunity to

earn a fair rate of return on the capital that it has invested in its utility enterprise. But, the Court failed to address the fundamental economic principal which the foregoing legal doctrine implicitly embodies: that economic regulation of utilities flows from the statutory mandate that utilities supply safe and reliable service and that the ratepayers pay a "just and reasonable" sum for that service based upon their use of the assets provided in the utility enterprise.

In exchange for its services, therefore, the utility is entitled to a reasonable opportunity to recover the cost of service *from the ratepayers* who occasion the cost. No more, but no less, is required of the ratepayer. It does not follow by any means that the ratepayer is then entitled to capital gains and losses on property purchased by the utility for use in the utility enterprise. Capital gains and losses simply do not form part of the *cost* of utility service. That is the reason ratepayers need not pay for the use of assets based upon their *value*. Since the capital gains and losses have only to do with the fact of ownership, the utility is entitled to the benefit thereof.

This Court has sharply distinguished between the public *use* of utility property and the property itself in defining the constitutionally protected limits upon ratemaking:

> The just compensation safeguarded to the utility by the 14th Amendment is a reasonable return on the value of the property used at the time it is being used for the public service. And rates not sufficient to yield that return are confiscatory. . . . Constitutional protection against confiscation does not depend on the source of the money used to purchase the property. It is enough that it is used

> to render the service. . . . The customers are entitled to demand service and the company must comply. The company is entitled to just compensation and, to have the service, the customers must pay for it. The relation between the company and its customers is not that of partners, agent and principal, or trustee and beneficiary. . . . The revenue paid by the customers for service belongs to the company. The amount, if any, remaining after paying taxes and operating expenses including the expense of depreciation is the company's compensation for the use of its property. If there is no return or if the amount is less than a reasonable return, the company must bear the loss. . . .
>
> Customers pay for service, not for the property used to render it. Their payments are not contributions to depreciation or other operating expenses or to capital of the company. By paying bills for service they do not acquire any interest, legal or equitable, in the property used for their convenience or in the funds of the company. Property paid for out of moneys received for service belongs to the company just as does that purchased out of proceeds of its bonds and stock. . . . *Board of Public Utility Comm'rs* v. *New York Tel. Co.*, 271 U.S. 23, 31-32, (1926) (citations omitted).

On this principle an entire body of constitutional law and accounting procedure has developed. With its development, the legal principle has been refined in its application to particulars.[3]

In Justice Brandeis' concurring opinion in *Missouri ex rel. Southwestern Bell Telephone Co.* v. *Public Ser-*

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[3] *E.g., Permian Basin Area Rate Cases*, 390 U.S. 747 (1968); *FPC* v. *Hope Natural Gas Co.*, 320 U.S. 591 (1944); *FPC* v. *Natural Gas Pipeline Co.*, 315 U.S. 575 (1942).

vice Comm'n, 262 U.S. 276 (1923), which greatly influenced the course of modern debate over fundamental application of constitutional provisions to utility rate regulation, he reviewed the fundamentals relevant here:

> The thing devoted by the investor to the public use is not specific property, tangible and intangible, but capital embarked in the enterprise. Upon the capital so invested the Federal Constitution guarantees to the utility the opportunity to earn a fair return. Thus, it sets the limit to the power of the state to regulate rates. The Constitution does not guarantee to the utility the opportunity to earn a return on the value of all items of property used by the utility, or any of them. . . . The owner is at liberty, in the absence of controlling statutory provision, to withdraw his property from the public service; and, if he does so, may obtain for it exchange value. *Id.,* 262 U.S. at 290.

Legislative regulation of public utilities was originally begun and developed in the public interest to counteract the lack of competition, not to appropriate their assets. The regulatory framework developed because it was demonstrated that utilities did not function effectively in a normally competitive atmosphere, due to their capital-intensive nature and the comparative inelasticity of demand for their commodity or service. Regulatory commissions such as the District of Columbia Public Service Commission were thereafter instituted to perform this function on a continuing and more responsive basis. The purpose of such regulatory agencies is, therefore, to stand in large measure between the utilities and the public and to serve the pricing function which competition would otherwise have served.

A utility enterprise such as Pepco remains comparable to non-regulated industry in that the use of assets in the utility enterprise gives no more right to its customers to any capital gains associated with that property than use of assets by any other industrial concern gives a similar right to its customers. As this Court held in the *New York Telephone Co.* case, *supra,* utility status does not alter this fact.

Here, WPIO claims that the net gains from the disposition of the property at issue should be credited to ratepayers (as a reduction in the revenue required to yield a reasonable return). Pepco and the Commission agreed that the net gains belong to the shareholders.[4] The Court of Appeals, however, came to a third conclusion: it held that the Commission, in its determination of the reasonable utility rate of return, should include a factor to reflect the effect of such gains and losses on the market price of the utility's stock. On remand, the Commission was directed to issue supplementary findings and conclusions on this wholly-unconstitutional consideration.

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[4] Pepco follows the Federal Energy Regulatory Commission's "Uniform System of Accounts" in keeping its books; this accounting convention was specifically adopted by the D.C. Commission in 1960. Pursuant to the "Uniform System," the risk of loss as to land value is placed upon utilities, not their ratepayers. Pepco treated the non-utility transactions in strict accordance with the "Uniform System."

The "Uniform System" is not mere custom. As recently as 1973, the Federal Power Commission by rulemaking reaffirmed its policy position with respect to the treatment of appreciation in the value of land assets for accounting and ratemaking purposes. Order No. 473, 49 FPC 390, 38 Fed. Reg. 4947 (February 15, 1973). That rulemaking specifically relied on the FPC's identical decision in *Duke Power Co.,* 48 FPC 1384, 1394-5, 97 P.U.R.3d 396, 405-06 (1972).

The consequence of permitting this decision to stand is yet another *uncompensated* risk thrust upon utility investors. The Court can take judicial notice of the current high interest rates; capital is scarce, the common stock of electric utilities as an industry is selling at a substantial discount from book value and attractive investment alternatives abound. Investor capital cannot be conscripted. Investors will not invest where the risk is greater or the reward less. In either case, whether investors choose to stay away, or have to be attracted with inordinately high earnings (by today's standards), future electric ratepayers will suffer needlessly.

II. The Court Of Appeals Would Require The Commission To Indulge In Unconstitutional Retroactive Ratemaking By Directing Pepco To Return Money Collected During The Effectiveness Of A Series Of Final Rate Orders Many Of Which Were Earlier Upheld By The Court Of Appeals

The Court of Appeals' remand would require the Commission to indulge in unconstitutional retroactive ratemaking: that is, the Court would require Pepco to return money collected during the effectiveness of a series of final rate orders issued between 1965 and 1974 (several of which were earlier upheld on review by the Court of Appeals).

None of the gains and losses from the disposition of assets occurred during the test period of the general rate case below. Therefore, the Court of Appeals has ordered the Commission to reflect past profits and losses in the setting of current rates. The rate orders covering earlier periods long ago became final. Profit, if any, from the locked-in periods covered by rate orders previously held valid cannot now be used to reduce revenue, otherwise just and reasonable, collected pursuant to any prior orders or pursuant to the final order which is the subject of this petition. *New York Tel. Co., supra,* 271 U.S. at 31; *Arizona Grocery Co.* v. *Atchison, T. & S.F.R. Co.,* 284 U.S. 370, 389-90 (1932).

III. The Court Of Appeals, Without Explanation, Greatly Broadened The Issue On Review In Comparison With The Issue Raised On Appeal, And In So Doing Required The Commission On Remand To Unconstitutionally Consider Non-Jurisdictional Revenue In Setting The Authorized Level Of Return From Jurisdictional Business

The Court of Appeals' holding below is as follows:

> Accordingly, we hold that when a regulatory commission calculates and approves an overall rate of return . . . for utility operations, based on comparative stock prices, it must factor into its determination an analysis of the impact of nonutility transactions on the price of the company's stock, including specific findings and conclusions as to whether—and why—the investors, the ratepayers, or both, have a claim to nonutility revenues, especially those derived from former utility property. . . . (Appendix D at 93)

The result of this holding is to require the Commission to consider the level of profit obtained by a utility from *non-jurisdictional, non-utility* transactions in setting the authorized return level with respect to jurisdictional utility business. Not only does this holding have no relation whatsoever to the precise issue raised on review by WPIO, but it also places an unconstitutional requirement on the Commission, which cannot raise or lower the authorized rate of return on jurisdictional utility business as the result of profits or losses from non-jurisdictional transactions. Utility rates in the District of Columbia must be based upon the cost of providing the utility service in that jurisdic-

tion. To take into consideration the results from other jurisdictions, including non-utility transactions, would result in rank subsidy, denial of due process and confiscation of Pepco's property. *Smith* v. *Illinois Bell Tel. Co.*, 282 U.S. 133, 148-50 (1930); *Dayton Goose Creek Ry. Co.* v. *United States*, 263 U.S. 456, 483 (1924); *Minnesota Rate Cases*, 230 U.S. 352, 435 (1913).

CONCLUSION

For these reasons, Pepco urges that this Court grant this petition for a writ of certiorari to the District of Columbia Court of Appeals, that this Court reverse the decision of that Court of Appeals and that this Court direct the Court of Appeals to sustain the Commission's determination that the gains and losses, if any, from the sale of non-utility assets belong to the company and not to its utility customers.

Respectfully submitted,

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July 30, 1979

APPENDIX

APPENDIX A

PUBLIC SERVICE COMMISSION OF THE DISTRICT OF COLUMBIA

1625 I Street, N.W., Washington, D.C. 20006

Order No. 5831

October 20, 1976

IN THE MATTER OF

Application of POTOMAC ELECTRIC POWER COMPANY for an Increase in its Retail Rates for the Sale of Electric Energy	))))	Formal Case No. 651

PROPOSED OPINION AND ORDER*

BEFORE: Ruth Hankins-Nesbitt, Chairperson;
H. Mason Neely, Vice Chairman; and
William R. Stratton, Commissioner

Procedural History

On December 29, 1975 Potomac Electric Power Company (Pepco) filed an application for an increase in rates for retail electric service in the District of Columbia which, as subsequently modified, was calculated to produce $57,578,000 in additional annual revenues. Concurrently

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* Since a majority of the Commissioners did not personally hear all of the evidence in this case, we are required to issue a "proposed" rather than a final order (D.C. Code 1973 Sec. 1-1509(d)).

filed was a Pepco request for an immediate interim increase of approximately $24,000,000, to be achieved by imposition of a 12.89% surcharge on all existing rates with the exception of electric current for street lighting.

Public notice of the filing of these applications was duly given, and on March 16, 1976, prehearing on the permanent increase and hearing on the interim request were held before the full Commission.[1]

By Order No. 5779, adopted April 15, 1976 the Commission granted intervention to six petitioners,[2] specified as issues the proper rate base, revenues, expenses, and rate of return for Pepco in the District of Columbia, and established hearing procedures and procedural dates.

There followed eleven days of hearings, during which testimony was received from eight witnesses for Pepco, two People's Counsel witnesses, one witness for the AC/DC Committee, three members of the Commission's Staff, and one consultant to the Staff. Through these witnesses a total of some 40 exhibits were introduced, and cross-examination produced a transcript of almost 2,000 pages. An additional hearing, to receive the views of interested citizens, was held on the evening of June 22, 1976 at the 14th Street PAC office.

The record was closed on June 11, 1976, oral argument heard on June 25, 1976, and briefs filed and the case taken under advisement by the Commission on June 29, 1976.

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[1] The interim increase request, denied on April 26, 1976 by Order No. 5782 (reconsideration denied, May 17, 1976, Order No. 5791), is pending on appeal before the District of Columbia Court of Appeals (No. 10909) and therefore will not be further addressed in this order.

[2] AC/DC Committee; All Souls Unitarian Church, Apartment and Office Building Association of Metropolitan Washington, Inc., *et al.;* Department of Transportation, District of Columbia Government; *et al.;* Department of Transportation, District of Columbia Government; General Services Administration (U.S.); and Washington Public Interest Organization, *et al.*

Preliminary Observations

For the fifth time in the past seven years, the Commission has again before it for decision an application by Potomac Electric Power Company for increased rates for retail electric service in the District of Columbia. In this case, as in its four predecessors, we again have the contention by Pepco that no matter what rate of return is found to be just and reasonable for Pepco, Pepco will be unable to earn it. Unlike the evidence of record in the four earlier Pepco cases, however, we have in this record substantial evidence that Pepco has turned the economic corner. Whereas the record in prior cases showed a declining trend in Pepco earnings, a trend without end in sight, Pepco's own evidence in this record projects a significant improvement in earnings in 1976 even without increased rates, and the accuracy of that projection has indeed been demonstrated by actual operating results reported by Pepco during 1976, of which we must and do take official notice.

We approach our decision in this case, therefore, without the anxiety inherent in an attempt to rescue a floundering if not drowning utility, admittedly unable to save itself, but rather with the objective of affording Pepco an opportunity to achieve an appropriate degree of financial stability and to earn a just and reasonable rate of return, while at the same time assuring that the retail electric customers of Pepco in the District of Columbia will pay rates no higher than necessary to afford Pepco that opportunity.

Perhaps because of the frequency with which Pepco has appeared before us in recent years, or perhaps because most of the issues involved in this case have so recently been decided by the Commission, or perhaps for other reasons of which we are not aware, only four parties, in addition to Pepco, actively participated in this case. Only three parties, in addition to Pepco, presented witnesses. Needless to say these parties—the AC/DC Committee, People's Counsel and our Staff—contributed significantly to

the making of the full and complete record necessary for us to reach an informed decision. Participation by the General Services Administration, representing the customer interest of the United States government, was also helpful, although it was directed primarily to rate structure and limited to cross-examination of witnesses and the submission of a brief. One other party, the Apartment House Council, actively participated in the rate structure phase of the proceeding, and its participation has also been most helpful to the Commission. A brief summary of the positions taken by these several parties and by Pepco will help identify the issues again or newly before us for decision. This summary, together with the fact that our most recent Pepco decision is less than a year old, will also help in shortening what otherwise might have been a somewhat lengthy opinion.

Positions of the Parties

(a) ***Pepco.***

In its application and supporting testimony, Pepco urged the use of calendar year 1975 as the test period in this case, with jurisdictional allocations being made on essentially the same average and excess demand method utilized in prior Pepco cases. Pepco also urged the use of a year-end rate base, reduced by approximately $8.8 million to account for an increase in accumulated depreciation and deferred taxes resulting from expense adjustments. Pepco's proposed December 31, 1975 rate base would include, in addition to plant in service, experimental plant, plant held for future use, an acquisition adjustment, preliminary survey and undistributed land transactions, construction work in progress, materials and supplies, cash working capital, and deferred fuel costs.

In its analysis of operating results for the test year 1975, Pepco would adjust these results to reflect annualization of its 1975 District of Columbia rate increase, the

1975 and expected 1976 wage increases, an increase in D.C. gross receipts taxes and a decrease in the D.C. franchise tax, the increase in depreciation expense approved by the Commission in 1975, an increase in 1975 pension costs and an increase in payments to Maryland environmental fund. Pepco would also adjust 1975 operating results to annualize 1976 Edison Electric Institute research and development contributions and to reflect the tax effects of the above adjustments and liberalized depreciation and the 4% investment tax credit.

On the rate of return question, Pepco suggests an overall rate of return of 9.75%, plus a .75% attrition allowance.

To achieve the earnings necessary to produce this 10.5% return on year end rate base Pepco proposes an across the board increase in basic retail rates, except for electric current for street lighting.[3] Pepco also proposes to revise its rate schedules by replacing the existing fuel adjustment clause with a current, zero based fuel clause which would also include net interchange results and would amortize deferred fuel expenses.

(b) ***People's Counsel.***

People's Counsel does not quarrel with the Pepco proposal to use calendar year 1975 as a test year or to use a year end 1975 rate base. People's Counsel does propose, however, a number of adjustments to the year end rate base calculated by Pepco. People's Counsel would eliminate expenditures for the Douglas Point nuclear plant, would deduct customer advances from construction work in progress, would eliminate undistributed land transactions, would deduct customer deposits, and would adjust cash working capital by using a "balance sheet" approach.

---

[3] Whether the D.C. government is liable to pay rates for electric current for street lighting in excess of 2 cents per KWH is the subject of litigation between Pepco and the D.C. government.

People's Counsel's recommendation for flow through treatment of the 4% investment tax credit and a four-year averaging of normalization of liberalized depreciation would also make necessary an increase in rate base to reflect the result of these two recommendations.

In reviewing operating results for calendar year 1975 People's Counsel suggests that the attrition allowance claimed by Pepco be removed, that revenue and expenses be adjusted to reflect the year-end decline in number of customers and increase in usage per customer, and that interest on customer deposits be reclassified to operating expense. As noted, People's Counsel would also adjust operating results to reflect the tax consequences of the proposed treatment of liberalized depreciation and the 4% investment tax credit.

With regard to rate of return, it is People's Counsel's recommendation that a just and reasonable rate of return for Pepco should not exceed 8.98%. The Pepco proposal to achieve a fair and reasonable rate of return through a flat across the board increase in rates is not opposed by People's Counsel, nor is the Pepco proposal for a zero based fuel adjustment clause.

(c) *Staff.*

Testimony by our Staff, as is the case with People's Counsel's witnesses, indicates agreement with the Pepco proposal to use calendar year 1975 as the test year and to use 1975 year end figures for, among other rate base items, plant in service. Staff does recommend, however, the elimination of amounts included in the preliminary survey and undistributed land transaction accounts, a reduction in cash working capital to reflect a revised lead-lag study and to remove compensating bank balances and prepaid insurance, and a further reduction in rate base in consideration of accounts payable related to plant in service and construction work in progress. Staff would increase Pepco's

proposed rate base to reflect its proposal to flow through the 4% investment tax credit, and would further increase rate base by using the average balance in the construction work in progress account, rather than the lower year end balance.

Adjustments to test period operating results proposed by Staff include a reduction in other operating expense to limit uncollectibles in the D.C. street lighting account, to remove management wage increases, to delete out of period expenses for the Academy of Natural Sciences, and to remove the commitment fee expense. The Staff also would reduce taxes to reverse the normalization of the 4% investment tax credit proposed by Pepco.

On the question of rate of return, Staff recommends an overall return of 9.06%.

Staff testimony does not address the question of basic rate structure, but although agreeing generally with Pepco's proposed fuel adjustment caluse, Staff recommends that the gross receipts tax be excluded in calculating fuel costs because such tax is a cost of sales rather than cost of fuel, and that the fuel costs themselves be determined on a three month moving average including 1-1/2 months of actual results.

(d) *Other Parties.*

As noted, GSA, the Apartment House Council and the AC/DC Committee expressed particular interest in the rate structure and fuel adjustment clause aspects of this proceeding. GSA and the Apartment House Council are in general agreement with Pepco's proposed across the board increase in basic rates. The AC/DC Committee alleges that all-electric customers are paying more than their fair share, and that Pepco should institute a "life line rate" for basic use customers. With regard to Pepco's proposed zero based fuel adjustment clause, Apartment House finds the use of estimates and the inclusion of deferred fuel costs

objectionable, while GSA urges that the fuel adjustment clause must recognize customer efficiency factors.

Discussion

(a) ***Test period, jurisdictional allocation, and year-end rate base.***

As indicated by these summaries, we may begin our own analysis of the issues in this case by noting general agreement on the use of calendar year 1975 as a test year in this case. The record also indicates that the jurisdictional allocation study submitted by Pepco has not been questioned nor has the use of a plant-in-service rate base calculated as of year end 1975.

We have in prior decisions agreed that use of most recent test period available is appropriate. We see no reason to depart from that view in this case, and we will therefore use calendar year 1975 for test period purposes. We note with interest that 1975 presented a picture of sharp contrasts, with the first half evidencing a continuation of the more than somewhat depressed conditions existing in 1974, but with the last half displaying significant improvement, an improvement that appears to be continuing in 1976.

We have also in previous Pepco cases thoroughly reviewed, analyzed and accepted the jurisdictional allocation study methodology used by Pepco in this proceeding and have found it appropriate. Having had the benefit of the results of other acceptable methods (*e.g.*, coincident and noncoincident peak) and discerning no significant difference among the three, we will again accept the results of the average and excess demand method in this case. As we have observed in prior cases, this method has the virtue of reflecting both peak responsibility and usage, and is therefore a sounder basis for jurisdictional allocation than peak responsibilities alone.

The question of using year end or average rate base has also been before us in numerous prior cases involving Pepco and other utilities operating in the District of Columbia. Our choice has been governed generally by our findings and conclusion with respect to the presence or absence of attrition. In view of the emphasis placed on this phenomenon by Pepco in this case, the attrition factor will be the subject of further discussion in connection with our review and analysis of the question of rate of return. Suffice it to say now, however, that the factor of attrition appears to be of far less decisional significance in this case than in prior Pepco cases. The continued increase in unit costs shown in this record, however, is sufficient evidence of the continued existence of attrition to again warrant the use of a year end rate base.

(b) ***Operating results.***

Having thus disposed of the issues in this proceeding which do not appear to have been the subject of serious dispute among the parties, we turn now to those involving greater controversy.

It is common practice among the parties to utility rate proceedings, and indeed quite acceptable as a regulatory technique, to adjust historical test year operating results to more accurately reflect current conditions and those that may be reasonably anticipated in the future. Adjustments for known changes occurring during the test period are generally non-controversial, and we have a number of that type in this case. For example, our approval in 1975 of a new composite depreciation rate for Pepco is responsible for and indeed requires two such adjustments in this case. Depreciation expense must be increased to reflect the new depreciation rate, and the depreciation reserve must also be increased to reflect the increased depreciation expense.

The parties have also proposed, and we find proper, adjustments to test year operating results to reflect the

annualization of the 1975 Pepco rate increase in the District of Columbia, the 1975 and 1976 Pepco wage and pension costs increases, and the changes in D.C. taxes and Maryland environmental fund contributions. All are known and definite changes which can be calculated with precision; and all are necessarily for consideration if the test period is to be representative of current and on-going conditions.

Other operating result adjustments, whether proposed by Pepco, by People's Counsel, or by our Staff, are contested by one or more parties. There is total disagreement, for example, on the subject of normalizing liberalized depreciation and the 4% investment tax credit. No two parties have proposed the same treatment of these items, and therefore in terms of operating results the tax adjustment proposed necessarily differs. We agree, as did the Staff, with Pepco's proposal to normalize liberalized depreciation. We agree with our Staff that flow through with averaging of the 4% investment tax credit is proper. As we will discuss in greater detail in addressing the rate base impact of the depreciation and tax credit adjustments, we see no necessity for identical treatment of these two items, and we believe that achieving a proper balance between the interest of the rate payer and the interest of the investor requires a difference in their treatment here, consistent, however, with the intent of Congress and proper regulatory accounting.

We also find proper and will accept the adjustments proposed by our Staff to remove anticipated 1976 management wage increases, to delete out of period expense for the Academy of Natural Sciences, and to remove commitment expense. With regard to the first two Staff adjustments, it appears to us that these are designed and indeed are necessary to eliminate out of period expenses which are neither representative of the test period nor of expected future conditions. With regard to the commitment fee expense, we agree with our Staff that this item

is more properly considered in the computation of the cost of capital for rate of return purposes, as has been done by the Staff rate of return witness.

With regard to the Staff's proposed adjustment to normalize the provision for uncollectibility related to billings for electric current for D.C. street lighting in excess of 2 cents per kilowatt hour, we have serious reservations. We have previously expressed our concern over the 2 cent limitation found in the District of Columbia appropriation legislation, a limitation which when the average cost of electric power and energy exceeds 2 cents (as it now does) may be construed to require subsidization of the District of Columbia government electric bills by the residential, commercial and other users of electricity in the District. We do not know whether this subsidization represents the intent or the will of the Congress. Indeed, it would be presumptuous of us to speculate on that question, particularly since this matter is a subject of a suit by Pepco against the D.C. government and this question presumably will be resolved in the near future by judicial decision.

For purposes of this case we will hold in suspense the outstanding balance in the Pepco electric current for street lighting account, which represents unpaid Pepco billings in excess of 2 cents per kilowatt hour from late 1973 to date. Our disposition of this matter is reserved for further order after the issues between Pepco and the D.C. government have been resolved by the courts.

Turning then to less troublesome operating result adjustments proposed here, we do not find persuasive Pepco's contention that operating results for 1975 should be adjusted to annualize estimated 1976 research and development contributions to the Edison Electric Institute. To make this adjustment, would, in our view, distort 1975 operating results and simply result in a mismatch of 1976 expenses with 1975 revenues.

Similarly, although we find persuasive in concept People's Counsel's proposal to adjust revenue and expenses

for 1975 by annualizing year end operating results to match year end rate base, we are unable to overcome the practical difficulties inherent in the assumption that a simple mathematical calculation based on a snapshot view of operations is or will be representative of future conditions. With regard to People's Counsel's proposal that we reclassify interest on customer deposits to operating expense, it appears that this recommendation is made for the primary purpose of consistency with People's Counsel recommendation the customer deposits be deducted from rate base. Inasmuch as we are not persuaded that customer deposits, which are not included in rate base, should nevertheless be deducted from rate base, it becomes unnecessary to consider the operating expense adjustment proposed. We must note, in passing, that the amount involved in the expense adjustment is insignificant and would have no effect on the end result which we will reach in this case.

To sum up our discussion of 1975 operating results, as adjusted to reflect what we perceive to be known changes and to make 1975 results reasonably representative of future conditions, we find that in test year 1975 Pepco's operating income was $56,216,000.[4]

(c) ***Rate Base.***

Turning from the test year operating results to the question of the appropriate rate base for Pepco in the District of Columbia, we again find major areas in which the parties

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[4] This figure is the result of the following calculation:

Operating Revenue		$223,576,000
Operating Expense		
Operation & Maintenance	$121,898,000	
Depreciation & Amortization	21,963,000	
Taxes	33,499,000	
Total Operating Expense		177,360,000
Operating Income		$56,216,000

to this case are in complete agreement. There is no dispute, for example, as to the amount to be included in rate base for electric plant in service, nor is there dispute over the amounts to be included for experimental electric plant, electric plant held for future use, or acquisition adjustments. Our Staff has again recommended, and we again agree, that amounts included in preliminary survey and investigation and land transactions undistributed are not properly included in rate base. These amounts may or may not be ultimately reflected in used or useful utility plant, and sufficient doubt exists as to ultimate use and the future time of use, if used, to warrant exclusion of these items from rate base.

It should be further stated for the record, that accepting the staff recommendation for treatment of Account 186.11, Undistributed Land Transactions in Formal Case 630, we reestablished the Commission's traditional position of excluding this account from rate base, considering the treatment of this item as a part of rate base in Formal Case 596 as an unintentional oversight of the Commission rather than as establishing a precedent. Therefore, the position that we are taking in this proceeding and in Formal Case 630 is wholly consistent with this Commission's longstanding prior position.

Our Staff has also once again recommended that the proper rate should include average construction work in progress (CWIP), rather than the year end amount shown in that account. Similarly, the Staff has also recommended the use of average amounts, adjusted to year end rather than year end figures, for materials and supplies. With regard to these items we agree with and will accept the Staff's recommendation for averaging CWIP. In prior cases we have consistently expressed the view that the use of average, rather than spot figures, are both more accurate in reviewing historical results and also are a more reliable indicator of conditions to be expected in the future. We find this to be equally true in this case, and we must

necessarily reject arguments against the use of the average CWIP, arguments which appear to be based simply on the fact that average in this instance is higher than the year end figure.

With regard to the Staff's proposal that an adjusted to year end average be used for materials and supplies, we are in agreement with respect to the averaging concept but are unwilling to accept the adjustment of the average to a year end figure. It appears to us that the adjustment proposed, based as it is largely on an expectation that fuel inventory in the future will be at a lower than average level, is surrounded by all of the uncertainties present in today's fuel markets. Here again, as in the CWIP area, we have a higher degree of confidence in an average figure, unadjusted by future predictions. Therefore, as we found proper in Pepco's last rate case (Formal Case No. 630), we will again accept average figures for materials and supplies.

One item of rate base calculation which provoked considerable discussion on this record was cash working capital. There is, of course, no question but that an allowance for cash working capital is properly includable as an item of rate base. The different opinions expressed in this case did not dispute inclusion, but rather the method of calculating the allowance for cash working capital.

Pepco, which initially proposed the use of the so-called FPC method (one-eighth of annual operating expense), abandoned its position during the proceeding in favor of the lead-lag method historically used by this Commission. As adjusted, the lead-lag study produced by Pepco was found acceptable by our Staff. People's Counsel's cash working capital proposal called for use of the "balance sheet" method. While we find this method to represent an interesting and novel approach to the determination of the proper allowance for cash working capital allowance, both the extreme result reached by that method in this case (a

negative allowance) and the fact that we are unaware of any other Commission having found that method acceptable is convincing evidence that we should not accept it here. As a matter of unquestioned fact, there is a lag between payments by Pepco of its bills (including, *e.g.*, payroll) and the rendering to and collection from its customers bills for electric service. If Pepco is to pay its bills, funds must be available, therefore, from a source other than revenues received from customers. No amount of theoretical adjustment of balance sheet figures can change that fact. We conclude, therefore, that an allowance for cash working capital is necessary and appropriate in this case; and we further find, as indicated above, that our traditional lead-lag study approach as applied by Pepco and our Staff produces a proper result here.

In summary then, we find that the proper rate base for Pepco in the District of Columbia as of December 31, 1975, is $764,884.000.[8] In reaching this conclusion we have, as above indicated, agreed with Pepco's proposal that rate base should be reduced to reflect the deferred taxes associated with liberalized depreciation. We believe this approach to be more consistent with the intent of Congress

[8] This figure is calculated as follows:

Plant in service	$754,519,000
Experimental plant	2,886,000
Plant held for future use	7,195,000
CWIP	123,316,000
Materials & supplies	34,988,000
Cash working capital	13,401,000
Deferred fuel cost	3,412,000
Total	$939,717,000
Less:	
Accumulated depreciation	168,791,000
Customer advances	6,000
Deferred taxes	6,036,000
Rate base	$764,884,000

in enacting provisions for liberalized depreciation and we believe it also will result in improved cash flow to Pepco and a more equitable spreading of the burden among present and future rate payers. We have also agreed with our Staff that the 4% investment tax credit has an independent existence from the asset which caused its creation, and will never be repaid nor will the basis of the asset be adjusted by the credit. Thus, flow through of the credit, on an average basis, as we have done in the past to accommodate year-to-year variations, is again proper in this case.

The question of excluding the Douglas Point nuclear project from Pepco's rate base has once again been raised in this proceeding. Although we recognize the concerns which prompt this recommendation, we are simply unable at this time to conclude that given the extremely long lead time involved in nuclear plant construction and the yet unresolved question of energy and fuel suppy in this country, expenditures thus far made by Pepco in Douglas Point are so improvident as to require their exclusion from rate base. Needless to say, we will continue to monitor this situation, and should future events dictate a different conclusion, we will be prepared to act promptly in that regard. In this connection, we are seriously concerned that a continuation of substantial expenditures for the Douglas Point project may reach a level at which, like it or not, we may be put in a position in which allowance of further expenditures may be said to be the lesser evil. To avoid this possibility, we hereby put Pepco on notice that in any future rate cases it will be required to bear the burden of proof, on a life-cycle cost basis,[6] of the economic prudence of its Douglas Point investment.

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[6] Life cycle cost basis is the discounted cost of plant, fuel, fuel related cost, and other operating cost from time period zero (the time of the study) through the plant's productive life.

Relating our findings with regard to 1975 operating results to our conclusion as to a proper District of Columbia 1975 year end rate base, it appears that during 1975 Pepco's earnings reflected a rate of return on year end rate base of 7.35%.

(d) ***Rate of Return.***

With this figure in mind we turn now to a discussion of the expert testimony in this record of the issue of what rate of return for Pepco from District of Columbia operations would be just and reasonable. Our task in reviewing and analyzing the expert testimony on the question of the fair rate of return for Pepco is made considerably easier by the fact that it was less than one year ago that we had occasion to consider and determine the same issue for Pepco, with the principal expert witnesses for Pepco and our Staff (Messrs. Reis and Kosh) who testified in this case having also testified in the last Pepco case. We also have the benefit in this record of additional expert testimony from Mr. Charles A. Benore and Dr. Matityahu Marcus, appearing for Pepco and People's Counsel, respectively.

Given our recent experience, we are necessarily then somewhat familiar with the traditional Pepco approach, exemplified by Mr. Reis' testimony, to a fair and reasonable rate of return, *i.e.*, a determination of the cost of equity on the basis of comparable earnings and alternative investment opportunities, including a risk premium. Also familiar to us is the emphasis placed by Pepco on its alleged desperately weak financial position, its need to sell common stock at above book, and its desire to sell additional equity in order to increase the proportion of equity in its capital structure.

We have also been most recently exposed to the discounted cash flow (DCF) approach utilized by the Staff witness on rate of return, an approach also utilized by Dr. Marcus for People's Counsel.

As in prior cases, there appears to be general agreement on this record with respect to the cost of debt, the cost of preferred stock, and the guiding principles of determining the rate of return as set forth in *Bluefield* and *Hope*.[1] Not unexpectedly, the basic difference between the testimony of the several rate of return witnesses here has to do with the cost of equity. In the context of this issue, we find ourselves in complete agreement with all of the expert witnesses that the cost of equity is not something that can be determined by simple arithmetic calculations. We must and we do recognize that expert testimony on rate of return, particularly on the cost of equity capital, is largely if not entirely based on that elusive concept of "informed judgment". Entering into this concept of informed judgment are studies and analyses of growth rates in earnings, growth rates in dividends, the selection of study periods and the determination of comparability. Each of these in and of itself necessarily involves an exercise of judgment on the part of the witness. This is not to say that all expert judgments in the rate of return area are necessarily subjective; or even if subjective, that subjective expert judgment is necessarily biased or incorrect. It would nevertheless strike us as somewhat unusual were we to find that the Company sponsored a witness whose informed judgment produced a lower rate of return than the informed judgment of, say, a witness sponsored by People's Counsel or the Staff.

We find it unnecessary here, in view of our discussion and evaluation of the rate of return question in the last Pepco rate case, to indulge in a detailed description of the methodology used by rate of return witnesses in this case or a repetition of our views and conclusions with respect to these methodologies. We again acknowledge, as we did

[1] *Bluefield Water Works & Improvement Co.* v. *W. Va. Pub. Serv. Com.*, 262 U.S. 679 (1923); *F.P.C.* v. *Hope Nat. Gas Co.*, 320 U.S. 591 (1944).

in the last Pepco case, the essential role played by informed judgment in determining a fair and reasonable rate of return for Pepco. We also again recognize that it is not our function, as a regulatory body, to determine the market price of Pepco's stock or to guarantee to Pepco's investors a fair return on their equity investment. Rather we must, in the exercise of our judgment, informed as it is by the testimony of record, endeavor to balance the interest of the ratepayers in the District of Columbia and the investors in Pepco's stock, in order to arrive at the ultimate conclusion that Pepco investors must be afforded an opportunity to achieve a reasonable return and that Pepco ratepayers should be required to pay no more than necessary in order to make available to Pepco investors that opportunity.

We remain persuaded today, as we were a year ago, of the infirmities in the Pepco comparable earnings approach. We also remain unconvinced of the need to add to the Pepco recommendation of a fair and reasonable rate of return an additional allowance for "attrition". Our analysis of the latter point in this case is greatly influenced by the fact that by Pepco's own testimony its earnings on equity are anticipated to increase very substantially in 1976 without any further rate relief from this Commission. We find wholly inconsistent, and indeed flatly contradictory, the assertion of severe attrition in earnings in the face of significant increase in earnings.

We also have had occasion in prior Pepco cases to express our views of the discounted cash flow (DCF) method, a method utilized in this case by both Staff and People's Counsel witnesses. In reviewing this testimony, we have concentrated on the judgment used by the DCF witnesses in selecting the growth and dividend factors, a judgment that is critical in terms of the result of the application of the DCF formula. We recognize, of course, that the judgments of expert witnesses will necessarily differ. But we find it interesting, and indeed more than a little persuasive,

that the two expert witnesses who utilized the DCF approach in this case have arrived at results differing by only approximately six tenths of one percent.

With respect to the testimony by Pepco's rate of return witnesses, we again note, as we did in the last proceeding, the substantial variations in earnings among the companies selected as being comparable to Pepco. We also find of interest the fact that even considered on an average basis, the companies selected as comparable to Pepco have experienced a substantially lower return on equity than that recommended by Pepco witnesses, but have nevertheless achieved a market to book ratio of approximately 1.3. And while all expert witnesses agree that market price should exceed book, the recommendation by Pepco witnesses of a return on equity which would result in market price being approximately double book value, approaches, in our view, the incredible. The comparison by Pepco of Pepco with food processors and tobacco companies appears to us to be totally meaningless. That the earnings on total capital of these groups appears to be in excess of the level of return conceded by Pepco to be fair for Pepco proves nothing in our judgment but a desire by Pepco for a higher rate of return.

Other testimony by Pepco expert witnesses on rate of return is equally unpersuasive. The relationship between return earned by Pepco and the return on risk free capital also proves too much, for by this test the asserted required return for Pepco would produce a market-to-book ratio of almost 200%, a ratio far in excess of that required to permit Pepco to seek new equity sufficiently above book value to avoid dilution.

Other efforts by Pepco expert witnesses to support the recommendation that Pepco must earn on the order of 15% to 15½% return on book equity appear to involve unbroken skeins of assumption upon assertion upon projection to arrive at a predetermined result. For example, the assumption that earnings per share for the Standard and Poor 435 industrials will grow at a rate parallel to that of the gross national product, with the GNP growth rate assumed at approximately 10% over the foreseeable future, is to us an interesting but meaningless statistic. History, as depicted on this record, suggests no relationship between these growth rates, and no reason to expect that these growth rates would be similar in the future. We also find it difficult to believe the testimony of Pepco witnesses that if Pepco's earnings rose by 50%, Pepco's market price would not rise. Yet this, is essence, is what Pepco's expert testimony would have us believe.

In short, and in summary, with all due respect to Pepco's admittedly expert witnesses, it appears that their testimony is designed primarily to afford a rationalization for an asserted Pepco requirement for higher earnings, rather than an objective evaluation of the cost of equity to Pepco in the marketplace. We therefore decline to accept the testimony of Pepco's witnesses, and rather will base our judgment on the testimony of witnesses for People's Counsel and our Staff which, as noted, with unexpected consistency concludes that a rate of return for Pepco on the order of 9% is just and reasonable under today's market conditions. We are persuaded that a return in the 9.0%-9.1% range is and will be just and reasonable for Pepco in today's economy. In view of the significant anticipated improvement in Pepco's earnings during 1976, an anticipation realized by actual performance, we will not only find reasonable but will accept for ratemaking purposes our Staff's recommendation of 9.06% as the basis for fixing retail electric rates in the District of Columbia in this proceeding.

In arriving at our judgment that 9.06% is a fair and reasonable rate of return for Pepco on its District of Columbia operations, we have also accepted the capital structure used by Staff witness Kosh.

The Pepco witnesses' view of capital structure, directed toward year end 1976, assumed issuance by Pepco of an additional $50 million in common stock and an additional $50 million in bonds, resulting in a projected capital structure in which equity would represent approximately 35%. We have seen no evidence thus far in 1976 that the issuances contemplated by the Pepco witnesses have become or are about to become a reality, and we have no reason to anticipate additional financing by Pepco on this order of magnitude between now (October, 1976) and the end of this year.

We do recognize Pepco's desire to increase its equity ratio. We are persuaded, however, that Mr. Kosh's appraisal of the situation is more realistic. Mr. Kosh proposes a capital structure as of December 31, 1976, which, allowing for flotation of $25 million of new equity and an additional $2 million of short term debt, would together with internally generated funds not only accommodate Pepco's proposed $110 million construction program and achieve an increase in the equity ratio, but would also be reasonable, safe, and allow adequate flexibility in future financing.

Mathematically, then, our rate of return and capital structure judgments can be expressed as follows:

Debt	55%	at	6.92%	3.81%
Preferred	11.8%	at	7.87%	.93%
Equity	33.2%	at	13.00%	4.32%
		at		
100.0%			9.06%	

We have given most thorough consideration again in this case to the question of attrition, and to Pepco's request for the addition of .75% to its recommended rate of return to compensate for attrition.

As we stated earlier in this decision, we do find in this record evidence that the phenomenon of attrition still ap-

pears to be present to a degree—a degree sufficient to warrant use of a year-end rate base—but we are not persuaded that we should add to this allowance another $12.8 million* to compensate Pepco for attrition.

We have two basic problems with the Pepco request. First, we are again troubled by the repeated Pepco refrain that no matter what return is authorized, Pepco will not be able to earn it. To fix District of Columbia rates on the basis of an additional $5.7 million revenue requirement would thus but impose an undue additional burden on the ratepayers in the District of Columbia without a commensurate benefit to Pepco. Second, and more significant, we are persuaded by the evidence here before us that although attrition remains a factor in this case, its impact is far less serious that it has been in the past.

As pointed out by People's Counsel, Pepco's own testimony is that the rate of inflation will be lower in 1976; that internally generated funds will almost suffice to cover the reduced construction budget; that sales are once again showing an increase, and that with the proposed change in the fuel adjustment clause, only 11% of plant related costs have the potential for causing attrition. Moreover, Pepco's testimony also shows that even without rate relief in this proceeding, the company's earnings on equity are expected to increase during this year from a low of 7.86% in late 1975 to 11.5% in late 1976. We find it quite difficult to find attrition, normally associated with declining earnings, in the face of a 37% increase in one year in earnings on equity.

Having concluded that the proper District of Columbia rate base for this proceeding is $764,884,000, and that

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* The Pepco $12.8 million figure appears to relate to total company operations, since using the Pepco formula of .75% on rate base would produce, for D.C. operations, an attrition allowance of $5.7 million.

operating income for the test year of 1975 realized by Pepco is $56,216,000, and that the just and reasonable rate of return for Pepco on District of Columbia operations is 9.06%, all necessarily mathematically resulting in the finding that Pepco is entitled to a revenue increase of $29,411,000,[9] we must then turn to the question of what changes in Pepco's existing rate schedules are necessary and appropriate in order to achieve this overall dollar result.

(e) *Rate Schedules.*

Pepco has proposed that the revenue deficiency which it confidently anticipated that the Commission would find be made up by an across the board increase for all retail rate customers in the District of Columbia. Somewhat surprisingly, in view of the tremendous interest in the rate structure and rate schedule issue in Formal Case No. 630, the current Pepco basic rate schedule proposal encountered resistance in this case on only a few points. To the extent that this phenomenon may be attributable to the knowledge of the parties in this case of the several rate schedule studies we ordered Pepco to undertake, we regret and are deeply disturbed by the lack of significant progress by Pepco toward completion of those studies. We expect and we direct Pepco to give priority to these studies with a view toward their prompt completion; and we will instruct our Staff to give us monthly reports on Pepco's progress in this regard.

In the context of basic rates, three points were raised by the AC/DC Committee. The Committee's principal general concern, that all-electric customers are paying more

[9] The calculations are as follows: return at 9.06% = $69,298,000, thus a deficiency in return of $13,082,000 was experienced by Pepco during the test period. Using 44.48% as the complement of the composite tax rate produces the additional revenue requirement of $29,411,000.

than their fair share, became more specifically directed toward an alleged discrimination in the treatment of all-electric customers and electric water heating only customers. Although the Committee and Pepco agreed in principle that an adjustment should be made in the point at which the all-electric customer would get the benefit of the water heating rate, there was disagreement as to the location of the point. We also agree with the principle that this discrimination should be eliminated. As to the proper location of the point—the Committee suggests 500 KWH, and Pepco proposes 800 KWH—we will direct Pepco to fix the point at 750 KWH, a level which on the evidence of record appears to us to represent an equitable solution.

The Committee also proposes, and Pepco agrees, that the restriction on availability of the all-electric rate schedule contained in our order in Formal Case No. 630 should be eliminated.[10] The parties contend that serious problems of discrimination among tenants and among owners arise from the existing restriction, *e.g.*, does the restriction apply to the dwelling or to the customer. Also pointed out are the problems of obtaining alternate energy sources, whether for new homes or those being restored or remodeled. We are disposed to agree that the existing restriction may create problems more serious than the problem to which it was addressed. We therefore agree that the restriction should be eliminated.

The third point raised by the Committee, a proposal for a "lifeline" rate, has substantial appeal in terms of apparent benefit to low usage customers. We are concerned, however, over the detail involved in and the revenue impact of this proposal, matters which cannot be resolved on this record. We remain unpersuaded, nevertheless, as we

[10] No new all-electric residential customers may avail themselves of the all-electric rate schedule for service begun after January 1, 1977. (See Commission Order No. 5759, page 13.)

were in the last Pepco case, that the basic use customers, *i.e.*, those using less than 450 kilowatt hours per month, are in any way responsible for an increase in Pepco revenue requirements. We therefore adhere to our view, as expressed in our last Pepco decision, that there is neither need nor justification for increasing rates for these basic use customers. We will therefore require that Pepco present for our consideration rate schedules designed to achieve $29,411,000 in additional revenue without increasing the rates for use of less than 450 kilowatt hours of electric energy per month within the District of Columbia. Subject to this condition, and the changes in the all-electric schedules discussed above, we are in agreement with the Pepco proposal that the additional revenue requirement be achieved by an across the board increase in the rates for retail electric customers within the District of Columbia (except energy used for street lighting).

Turning now to the rate applying to electric current for District of Columbia street lighting, we are setting such rate at 2 cents per kilowatt hour. After the courts resolve the dispute between the District of Columbia Government and Pepco concerning street lighting energy, the Commission will reconsider the rate to be charged for such energy. (See pp. 12-13)

(f) ***Fuel Adjustment Charge.***

There remains a question, considerably disputed on the record of this case, of changes in the existing fuel adjustment clause. This clause now represents a substantial portion of the charge for electric energy for retail use in this jurisdiction. We are persuaded of the correctness of Pepco's view that a current, zero based fuel clause will more accurately and more equitably reflect the significance of fuel costs as a factor in the cost of electric service to customers in the District of Columbia. We also agree with Pepco that the net results of the interchange arrangements with the PJM group, based as they are largely on the cost of fuel, are properly includable in the calculation of the fuel adjustment charge. We also find ourselves in agreement with the position taken by the Apartment House Council that costs subject to the Company's control, such as the costs of leasing railroad cars and pipeline operations, should be excluded from the fuel adjustment charge. Whereas the cost of fuel is essentially determined in the marketplace, the cost of leased railroad cars and owned pipeline operations, while contributing to the delivered cost of fuel, can be controlled to a significant degree by Pepco and are more properly included for recovery in the base rate, not through operation of the fuel adjustment clause. We will therefore require Pepco to present for our consideration and approval a fuel adjustment clause conforming to the view expressed herein.

As this summary discussion indicates, questions relating to the fuel adjustment charge generated far more interest than did questions concerning the basic electric energy rate. We recognize the significance of these questions in this case, coming so soon after our decision on the fuel adjustment clause proposed in Formal Case No. 630, where we expressed our concern over the potential lack of management incentive to minimize fuel costs in the face of a clause that essentially guaranteed recovery by Pepco of whatever fuel costs might be incurred. On this record, however, there is no evidence that the necessary management incentive is lacking.

Interchange transactions, however, fall in a completely different category. Whether Pepco sells or buys, and in what amount, in either event, is for all practical purposes totally beyond Pepco's control. These transactions depend on an almost infinite variety of circumstances, many of which are involuntary on the part of any particular member of the PJM group or, if voluntary, are free of any approval or disapproval by Pepco. Inasmuch as fuel costs are critical to, if not wholly determinative of, the price of

these interchange transactions, we find that their inclusion in computing charges (or credits) under a fuel adjustment clause to be wholly appropriate. To illustrate the significance of inclusion of PJM interchange transaction, our Staff points out that the level of net interchange sales ranged from a high of 52% of system sales in December, 1973 to a low of 1.9% of system sales in June, 1975. Again, the cost of fuel and the level of interchange transactions are basic to the effect of variations such as this on the cost of electric energy to District of Columbia ratepayers.

Our Staff, agreeing in principle with the fuel adjustment clause proposed by Pepco, nevertheless suggests two modifications in the mechanics of its computation.

First, Staff recommends, and we agree, that use of a three month moving average of fuel costs, beginning with the second month prior to the billing month, rather than with the billing month itself, would provide a more current determination of current fuel costs.

Second, Staff recommends, and we again agree, that the gross receipts tax on revenue received by Pepco from charges for electric service in the District of Columbia should be recovered by Pepco as a cost of sales, rather than as a cost of fuel.

With regard to inclusion of an efficiency factor in the fuel adjustment clause, as proposed by GSA, we agree that efficiency is a factor that should be recognized in ratemaking for electric service. In our judgment, this factor should be reflected in the fuel adjustment charge.

Summarizing our conclusions with respect to Pepco's proposal for a new fuel adjustment clause, we will accept and approve a new clause consistent with the views we have expressed. Our purpose is to obtain for Pepco customers in the District of Columbia the benefit of increases in interchange sales, while at the same time avoiding annual Pepco rate increase applications when intercahnge

sales decline or when the cost of fuel appears to be fluctuating beyond a reasonable range. Should fuel costs remain relatively stable, no appreciable change in amounts paid by Pepco customers in the District of Columbia will result. Should fuel costs decrease or interchange sales increase, customers will immediately benefit, without waiting for the next Pepco rate case. Only if fuel costs increase in an amount not offset by interchange sales could District of Columbia customers find their Pepco bills increased. Apart from the possible avoidance of future rate cases, with the unavoidable costs involved in such proceedings, it appears that approval of a zero based fuel clause, modified in accordance with the views herein expressed, will prove to be of benefit to D.C. customers of Pepco.[11]

Subject to these conditions with respect to rate schedules and the fuel adjustment clause, we will authorize Pepco to increase its rates for retail electric energy sales within the District of Columbia (other than street lighting energy and residential use under 450 KWH) by an amount sufficient to achieve the additional earnings found appropriate in this order.

(g) *Other matters.*

Two other matters presented or arising in the course of this proceeding require disposition before we mark this case "closed".

The first is the ratemaking adjustment proposed by the Washington Public Interest Organization (WPIO), an organization concerning which the record reveals nothing except that it appears to be represented by counsel. We note that the same counsel appeared for the same organi-

[11] We also believe that amortization over a four year period of the balance remaining in the deferred fuel cost account, as proposed by Pepco and found reasonable by our Staff, is a fair and equitable method of handling this matter.

zation in Formal Case No. 630, raising the same issue presented here, an issue decided adversely to his contentions in that case.

Nevertheless, we are apparently faced with the necessity of again deciding in this case the same issue on which a decision adverse to WPIO counsel's interest was rendered in Formal Case No. 630 on the question of whether Pepco revenue requirements should be reduced because of any realized gain on the sale or transfer of Pepco property previously devoted to the public service. Our decision, which we believed to be correct at the time (apparently without serious disagreement by counsel for WPIO since judicial review was not sought) must now be summarily restated.

First, we still and again do not view the decision by the U.S. Court of Appeals for the District of Columbia Circuit in *Democratic Central Committee* v. *WMATC*, 485 F.2d 786 (D.C. Cir. 1973) as binding on this Commission as a matter of law. We would point out, as we did in our earlier decision, that our conclusions are now subject to review by a different court, the District of Columbia Court of Appeals, a tribunal whose views of even the D.C. Transit case before the Federal court in *Democratic Central Committee* might well have differed from those of the Federal court.

Second, we were and we remain convinced that the peculiar and unique facts involved in the *Democratic Central Committee* case, which apparently were dispositive of the issue before the court in that case, are not present in the case here before us. As counsel for WPIO here represented to the Court in the earlier case, "The Court of Appeals holding was based upon the particular and unique facts . . . of this case . . . and is not a general holding relating to other kinds of assets or to other utilities."

Curiously and strangely, counsel for WPIO would now have us to be controlled by a decision which he urged on

the Court as being "based upon the particular and unique facts" of that case.

We would be willing to acknowledge that flexibility on the part of counsel is a necessary part of proper client representation. We cannot, however, agree that facts which are "particular and unique" to a particular case have general applicability. And to us, the facts of the D.C. Transit case on which the court based its decision in *Democratic Central Committee, supra*, are indeed so "particular and unique" as to require a different decision on the facts before us here.

As the record here shows, without question, the properties involved in the WPIO argument were not acquired by Pepco at a price below book value, nor were they acquired under any special or unique circumstances such as those existing at the time of enactment of the D.C. Transit franchise act. Moreover, accounting treatment by Pepco of the acquisition of these properties and their disposal has been in full accord and compliance with the system of accounts prescribed by the Federal Power Commission and by this Commission.

Accordingly, we reject the WPIO counsel's contention that Pepco's revenue requirement should be reduced to reflect gains on the sale and transfer of Pepco property previously devoted to public service use. Should counsel for WPIO disagree with our reiteration of this conclusion and this time seek judicial review, we will of course aggressively defend our conclusion but necessarily will abide by final judicial resolution of this question.

In bringing this fifth Pepco case in seven years to a conclusion, a matter which has been of yet unspoken concern to the present members of the Commission, and we assume was also troublesome to our predecessors, must now in our judgment be frankly addressed and resolved.

In prior orders of the Commission, we have expressed our concern over the repeated assertion by Pepco that no

matter what rate of return was found fair and reasonable by the Commission, Pepco would be unable to earn it. Concern has also been voiced in the area of rate design, including time-of-day and peak load pricing, flattened or inverted rate schedules, and incremental cost pricing. On this record and in Formal Case No. 630 questions have been raised concerning load forecasting and system planning. Fuel procurement policies and methods have also been a subject of discussion, as has the matter of customer relations. The latter item, customer relations, has increased in significance in recent years because of the sharp and substantial increases in the cost of electric service.

In our judgment, the piecemeal approach over time to selected items of concern has contributed little to resolution of what appears to us to be a more basic problem, *i.e.*, a need to assure ourselves and the electric ratepayers in the District of Columbia that Pepco's operations are being conducted in the most efficient manner possible; and that its apparent inability to earn previously authorized rates of return is not due to circumstances over which Pepco may have a substantial degree of control.

We are aware of but one way in which we can obtain the necessary assurance—a "management audit" of the totality of Pepco's operations in the District of Columbia. Our use of the term "management audit" is not intended to suggest either doubt or suspicion that Pepco is not efficiently managed and operated.

We are convinced, however, that the time has come, if indeed it has not been here already, for us to take action to eliminate any uncertainties concerning Pepco's operations. We will therefore promptly select an appropriate and qualified agent to conduct a management audit of Pepco's operations with all deliberate speed and to report to us his findings and conclusion with respect to all aspects of Pepco's performance. Pepco will of course cooperate fully with our agent, and make available to him any and all

documents and data needed for a thorough and complete review.

At this juncture, the Commission takes notice that in Order No. 5739, two studies[12] were to be performed by the Company. The Commission is disturbed that as of this date these studies have not been completed. It is the Commission's view that the delay in completion has been due, in great measure, to the Company's less than prompt handling relating thereto. Accordingly, in order to provide an incentive to the Company to do everything possible to assure expeditious completion of the management audit, the Commission, before acting upon any future rate increase applications, will give serious consideration to the wisdom of proceeding before the management audit is completed.

FINDINGS OF FACT AND CONCLUSIONS OF LAW

Based on the record made in this proceeding, the Commission finds and concludes the following:

1. The 12-month period ended December 31, 1975, with appropriate adjustments, is the proper test year upon which to determine the Company's revenue requirement.

2. The Company's District of Columbia adjusted operating income for the year ended December 31, 1975 is $56,216,000.

3. The end-of-period allocated rate base as of December 31, 1975 is appropriate for determination of the Company's District of Columbia revenue requirements, and the adjusted end-of-period rate base for the test year is $764,884,000.

4. A fair rate of return on the Company's District of Columbia investment is 9.06 percent.

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[12] Relating to peak load pricing and residential tenants of apartment houses.

5. The level of return called for by the application of the 9.06 percent rate of return to the adjusted end-of-period rate base of $764,884,000 for the test year is $69,298,000.

6. The Company's adjusted District of Columbia operating income of $56,216,000 for the test year was insufficient by $13,082,000 when compared with the rate of return developed by applying a 9.06 percent rate of return to the test year end-of-period rate base of $764,884,000.

7. The adjustment which would raise the test year revenues to the level of the gross revenue requirement computed in accordance with the foregoing proposed finding is $29,411,000, including the allowance for taxes.

8. The revenue requirement is to be achieved by proportionately increasing those rates presently in effect with the following exceptions:

a. There should be no increase in the residential customer rates for levels of monthly consumption below 450 kilowatt hours.

b. Electricity supplied to the Street Lighting class of service should be set at 2¢ per kilowatt hour.

c. Rates should be designed to allow the all-electric customers to benefit from the water heating rate beginning at the 750 kilowatt hour level of usage.

9. The fuel adjustment rider of the Company's rate schedules should be revised to reflect the following changes:

a. The present computation of the base cost of fuel should be eliminated to effect a zero base fuel adjustment.

b. The net results of interchange power transactions should be included in the calculation of the fuel adjustment charge.

c. The cost of leasing railroad cars and of pipeline operations should be excluded from the fuel adjustment charge.

d. The fuel adjustment charge should be calculated by the use of a three month moving average of estimated cost and estimated kilowatt hour sales with an appropriate adjustment for actual results.

e. Gross receipts tax on revenue from charges for electric service in the District of Columbia should not be recovered through the fuel adjustment charge.

f. Inclusion of an efficiency factor, recalculated annually, to compensate for differences in transmission and distribution efficiencies.

g. The fuel adjustment charge should include an adjustment for the amortization, over a four year period, of the remaining balance of the deferred fuel cost.

10. Application of the All-Electric rate schedules could be extended to include all All-Electric residential customers regardless of dates of construction of their residences.

11. A management audit should be conducted by independent consultants selected by the Commission to determine the relative level of efficiency at which the Company operates. Such study would be commenced immediately and the Commission should give serious consideration to the wisdom of proceeding with hearings for any additional rate increases before the management audit is completed.

12. The increased rates and charges allowed the Company in this Opinion are just, reasonable, and non-discriminatory and non-preferential.

We have, in short, exercised our best judgment on the issues presented in the record before us; and we have achieved, to the greatest degree humanly possible, that delicate balance of the interests of ratepayers and investors that was our goal at the outset of this case.

Therefore, it is ordered:

1. That Pepco shall prepare, and submit for our approval, rate schedules for retail electric service in the District of Columbia, consistent with the terms of this order, reasonably calculated to produce additional revenue of $13,082,000 operating income which when added to test year revenues of $233,576,000 will produce gross revenues of $246,658,000.

2. That on a District of Columbia rate base of $764,884,000, which we find appropriate, the annual revenues herein authorized would represent a fair and reasonable rate of return of 9.06%.

3. That upon subsequent approval by the Commission of rate schedules herein ordered to be filed by Pepco, this proceeding is terminated.

4. Parties adversely affected by this proposed opinion and order may file exceptions on or before November 1, 1976, designating those portions of this proposed opinion and order to which they except and those portions of the record which they wish to be considered as supporting their exceptions.

5. If no exceptions are filed, this proposed opinion and order will be adopted as a final order effective November 8, 1976.

6. If exceptions are filed, oral argument on exceptions will be held in Room 314, 1625 I Street, N.W., on Novem-

ber 8, 1976 at 10:00 a.m. Copies of any exceptions shall be served on all parties to this case.

A TRUE COPY:

By the Commission:
/s/ RUTH HANKINS-NESBITT
Ruth Hankins-Nesbitt

Chairperson

/s/ MARY F. SPURLOCK
Chief Clerk

Majority Opinion By:

Ruth Hankins-Nesbitt, Chairperson
H. Mason Neely, Vice Chairman

Concurring Opinion By:

William R. Stratton, Commissioner

Order No. 5832

Errata

Section 1 of Order No. 5831 issued this date was inadvertently worded to direct the Potomac Electric Power Company (the Company) to prepare and submit for Commission approval rate schedules consistent with the terms of that order:

> "... reasonably calculated to produce additional revenue of *$13,082,000* operating income which when added to test your revenues of $233,576,000 will produce gross revenues of *$246,658,000.*" (Underscoring added)

In fact, Section 1 should have been worded to direct the Company to submit rate schedules calculated to produce additional revenues of $29,411,000 *based upon an increased operating income of $13,082,000,* which when added to test your revenues would produce gross revenues of *$262,987,000.*

This inadvertent error was also made by the Commission in its comments made at the "sunshine hearing" of this date at which Order No. 5831 was issued.

THEREFORE, IT IS ODERED:

That Section 1 of Order No. 5831 is corrected to read as follows:

> "1. That Pepco should prepare, and submit for our approval, rate schedules for retail electric service in the District of Columbia, consistent with the terms of this Order, reasonably calculated to produce additional revenue of $29,411,000 based upon an increased operating income of $13,082,000, which when added to test year revenues of $233,576,000 would produce gross revenues of $262,987,000."

A TRUE COPY:

/s/ MARY F. SPURLOCK
Chief Clerk

By direction of the Commission:

/s/ MARY F. SPURLOCK
Mary F. Spurlock
Acting Executive Secretary

APPENDIX B

PUBLIC SERVICE COMMISSION OF THE DISTRICT OF COLUMBIA

1625 I Street, N.W., Washington, D.C. 20006

Order No. 5849

December 16, 1976

IN THE MATTER OF

Application of POTOMAC ELECTRIC POWER COMPANY for an Increase in its Retail Rates for the Sale of Electric Energy	))))	Formal Case No. 651

OPINION AND ORDER

BEFORE: Ruth Hankins-Nesbitt, Chairperson;
H. Mason Neely, Vice Chairman; and
William R. Stratton, Commissioner

The Commission has before it for consideration exceptions to its Proposed Opinion and Order adopted October 20, 1976 (Order No. 5831), duly and timely filed by People's Counsel, the U.S. General Services Administration (GSA), the AC/DC Committee, the Apartment and Office Building Association of Metropolitan Washington, Inc., and the Washington Public Interest Organization (WPIO), et al. The Commission has also had the benefit of oral argument on the exceptions held on Thursday, November 11, 1976, in which People's Counsel, the AC/DC Committee, the Apartment and Office Building Association and PEPCO participated.

We have given thorough consideration to each of the exceptions most ably presented by counsel for the parties who did not find our October 20th order to their complete satisfaction. We have not been persuaded, however, of the necessity or desirability to change or modify our Proposed Opinion and Order in any material respect. We remain of the view that our proposed resolution of the issues in this proceeding is in and will best serve the public interest. We will, therefore, deny all the exceptions to Proposed Opinion and Order and adopt it as our final Order in this proceeding. Our reasoning is as follows:

As a preliminary and general observation, we are constrained to note that we find nothing new in the exceptions presented to us. Rather, each exception is but a reargument of contentions already advanced by the parties through witness's brief of argument, contentions which were thoroughly considered and rejected in our Proposed Opinion and Order.

We will first address the exceptions taken by three of the parties (AC/DC, Apartment and Office Building Association, and GSA) to our determination that no increase in rates should be made applicable to the first 450 kilowatt hours of monthly usage by residential customers in the District of Columbia. In essence, these three parties argue that this determination is discriminatory and unsupported by evidence of record in this proceeding. In our analysis of this issue, we recognize, as indeed we must, that a flat percentage across-the-board increase applied to all rate payers in the District of Columbia would give the appearance of fairness and equity and would most certainly be less controversial. We must, however, take our responsibilities more seriously than would be the case were we guided by more appearances and an effort to be noncontroversial. We have been and we remain convinced that basic to fairness in utility rate making is the principle that those responsible for costs, particularly increased costs, should bear them. Given today's rising cost trends in the

electric utility industry it seems obvious to us that increased costs necessarily result from either an increase in the number of customers or increase in demand or usage by existing customers, or a combination of these two factors. The evidence in this record discloses that there has not been an increase in the number of residential consumers in the District of Columbia during the test period. Rather, the number of residential customers in the District at the end of 1975 was lower than it was at the beginning of 1975. Thus, the first factor that might be responsible for increased cost causation is not present here.

With regard to the second factor, increased demand or usage, it seems to us that as a matter of simple logic imposition of a usage ceiling of 450 kilowatt hours per month necessarily dampens, if indeed it does not preclude, growth in demand or usage below that ceiling of any degree of magnitude that could be said to be responsible for any significant increase in the cost of rendering electric service in the District of Columbia, whether those increased costs result from additional generation, higher voltage transmission lines, larger substations, or new or more expensive distribution facilities. Additionally, while we are aware of the fact that all residential users receive the benefits of our decision to maintain existing rates for usage of the first 450 KWH per month, we believe that greater benefit accrues to residents having a low or fixed incomes. This non-cost consideration is, in our judgment, a factor properly considered and well within our regulatory discretion.

Turning our attention to the other exceptions taken by the parties and for convenience taking the parties in alphabetical order, we will first address the renewed contention of the AC/DC Committee that all electric residential customers in the District of Columbia provide Potomac Electric Power Company with a far greater rate of return than the total residential class. We note that by AC/DC's own figures the all-electric residential class is providing Potomac Electric Power Company with approximately

109% of its long run incremental cost of service. The AC/DC figures were seriously challenged by Potomac Electric Power Company which pointed out, among other things, that the AC/DC calculations did not, in fact, use LRIC, but rather used an imbedded cost of generating plants of approximately $160 per kilowatt, whereas the cost of new generating units is on the order of $600 to $900 per kilowatt hours. Faced with that fact we are not persuaded either as to the correctness of the AC/DC calculations, or even were we to assume their correctness, that 109% of long run incremental costs represents an excessive recovery by Potomac Electric Power Company from the all-electric residential customers. Moreover, we believe it inappropriate to use long run incremental costs for one single determination in a proceeding in which all other calculations are based on historical costs.

The AC/DC Committee also renews its contention of discrimination in the applicability of Potomac Electric Power Company's water heating rider as it applies to all-electric customers. We agree with the AC/DC view that the transcript on this point seems to confuse rather than clarify the matter, and we also agree that the water heating rider has been given a significance disproportionate to its importance.

There is ample evidence in the record to support establishing the cut-over point for water heating rate billing of all-electric customers at 750 kilowatt hours. AC/DC points to an alleged inconsistency between this approach and the approach taken in the WH rider as it applies to non-all-electric customers. In the latter case, the rider provides that the last 500 kilowatt hours of usage per month will be billed at the WH rate. Thus, the cut-over point in the WH rider differs from customer to customer and from month to month, depending on total electric usage. Given this fact, it is readily apparent that we are dealing with two different groups of customers having two different yardsticks by which their usage is measured. Thus, it is

not possible to simply select a single KWH number for application to both groups with the assertion that consistent treatment would then be achieved. Whether costs or other rate making considerations warrant further study of this matter is a question we are content to leave to the future. For now, we are satisfied that the adjustment of the cut-over point in the all-electric schedule achieves substantial equity between the two groups of customers.

Still proceeding alphabetically, the Apartment and Office Building Association takes exception to the inclusion in the fuel adjustment charge of items in Account 151 other than the invoice price of fuel. As the record shows we have given deep and detailed consideration to the question of the fuel adjustment charge over the past several years. The operation of the existing fuel clause is the subject of continual review by our Staff and the question of a proper fuel adjustment clause was the subject of an independent report to us by Haskins & Sells. Although the Apartment and Office Building Association appears to suggest we have "indiscriminately included all items in Account 151" in the fuel adjustment clause, this assertion more than somewhat overstates the case. As a matter of fact, the only other major item in Account 151 which would be included in the fuel adjustment clause is transportation charges. The cost of transportation, in common with fuel costs, bulks large in a utility's operations, and, like fuel, is beyond the company's control. If the purpose sought to be served by a fuel adjustment clause is to be met it should cover fuel transportation expenses.

Certain expenses within the Company's control have been excluded from the FAC at the behest of the AOBA. Other items as to which no large and uncontrollable changes were shown to exist are contained in Account 151 but not eliminated from FAC Treatment. The inclusion or exclusion of these other items would make little or no difference in the amount paid for electric energy by Potomac Electric Power Company's customers. These amounts

would be recovered in base rates if they were excluded from fuel adjustment clause treatment. By virtue of the monthly audit of the fuel adjustment account, these items will come under intensive, periodic staff review. We will therefore deny this exception of the Apartment and Office Building Association.

While on the subject of the fuel adjustment clause there is one point in our proposed order which, while not the subject of an exception taken by any party, requires clarification. That is the calculation of the amount of the deferred fuel charges to be amortized over the specified four year period. On the record in this case, we have determined that calendar year 1975 is the appropriate test period. At the end of that year, the balance in the deferred fuel account was approximately $4.5 million. Although we are aware that this balance fluctuates over time, we are limited to facts of record and are therefore constrained to use the year-end balance figure as the amount to be amortized over the four-year period. The final balance in the deferred fuel account will be determined after phase-in of the new FAC. Should Potomac Electric Power Company request the amount finally determined in a future proceeding, we will at that time consider the advisability of adjusting the amount to be amortized to the actual final balance in order to remove any residuum in this account or reduce the amount to be amortized as determined on the record.

We also reject the GSA contention that the management audit ordered in this case must be conducted in a formal proceeding.* The management audit represents an effort by this Commission to obtain basic information and data concerning the operation of Potomac Electric Power Company. This effort is not a proceeding, formal or informal,

* GSA also suggests that the rate structure studies ordered last year in Formal Case No. 630 should have been the subject of formal proceedings. We reject this suggestion as obviously untimely, as well as unsound.

in any sense of the word. Should the information and data obtained as a result of this effort suggest a necessity or desirability of instituting a proceeding, the Commission will, of course, do so; and it will afford GSA and any other interested party an opportunity to be heard.

Insofar as our statutory charter is concerned we find nothing to support GSA's assertion that we are powerless to investigate the operations of utilities in the District of Columbia except through formal proceedings. We agree with GSA that "the Public Utilities Act also clearly specifies the form which shall be taken by an investigation of the Commission relating to 'any regulation or Act whatsoever affecting or relating to . . . the production, transmission, delivery or furnishing of . . . (electrical) power,' " but we would note that D.C. Code Section 43-408, cited by GSA, quite clearly provides that the Commission may, ". . . in its discretion, proceed, with or without notice, to make such investigation as it may deem necessary or convenient." That section does indeed require formal hearing before we may enter an order affecting rates, charges or regulations. But it and other sections of our statute equally clearly contemplate precisely the approach we have followed in Formal Case No. 630, as well as in this case, *i.e.*, to conduct in our discretion, with or without notice, any investigation we deem necessary or convenient.

With regard to the contention by counsel for the Washington Public Interest Organization that the decision by the United States Court of Appeals for the District of Columbia Circuit in *Democratic Central Committee* v. *WMATC*, 485 F.2d 786 (D.C. Cir. 1973) is the law, we need add little to what has already been said in our Proposed Opinion and Order.

In sum, our reasons there for rejecting the contention of WPIO that gains on the sale and transfer of Potomac Electric Power Company property previously devoted to public service belong to the ratepayers were, and are, first,

that decisions of the U.S. Court of Appeals the District of Columbia circuit are not binding on this Commission as a matter of law; second, the particular and unique facts of the D.C. Transit case before the federal court in *Democratic Central Committee* are so different from the facts involving Potomac Electric Power Company in the case before us as to certainly warrant, if not indeed, to require a different result. Also, to lay to rest the assertion that our conclusion is based upon a slavish observance to the Uniform System of Accounts, two points bear making: first, the accounting system follows Commission policy determinations and not vice versa; second, even under this Commission's adopted system of accounts discretion is reposed in the Commission to follow or not to follow the rate making treatment urged by WPIO. Our decision on this matter represents the exercise of that discretion.

Parenthetically, in order that our disposition of this matter be totally clear we intended no implication that WPIO counsel's representation to "the Court" concerning the uniqueness and limited applicability of the *Democratic Central Committee* case was made to the Court of Appeals. The representation was indeed made, as counsel suggests, to the United States Supreme Court, and it was for this reason that our reference was to "the Court" (emphasis supplied).

Additionally, as counsel also suggests, we have no way of knowing the Court's reasons for not granting certiorari in the *Democratic Central Committee* case. Our discussion of WPIO counsel's position before the Court was not intended to suggest omniscience, but only to indicate our agreement with counsel that the particular and unique facts of the D.C. Transit case precluded the *Democratic Central Committee* holding becoming "a general holding relating to other kinds of assets or to other utilities."

We turn last, but certainly not least, to the exceptions filed by People's Counsel in this case. After consideration

of those exceptions, however, we remain unconvinced of the wisdom of the positions taken by the witness for People's Counsel with respect to cash working capital and with respect to annualizing revenues and expenses to reflect year end customers and projected use.

Addressing first the question of cash working capital, we are compelled to note the possibility of conceptual commingling, and consequent confusion, that can arise in discussion of this subject.

Cash working capital is the amount of money required to bridge the gap between the time expenses are incurred in providing utility service and the time the revenues related to that service are collected. Electric utility service is billed for after it is rendered. At any given time the utility has advanced funds to meet the costs of services already provided and for which it has not been paid. This advance of funds is recognized in rate making by including it in a utility's rate base.

There are several ways in which the amount of cash working capital can be determined. Under the so-called "formula" method, an amount equal to one-eighth of a year's expenses (or some number of days expenses) is established as the time period during which the utility has advanced funds to meet the costs of services already provided and for which it has not been paid. Under the "lead-lag study" method used by this Commission, a precise calculation of the amount involved is made by netting the lag in payment of operating expenses against the lag in receipt of utility revenues.

Under another method, current liabilities are subtracted from current assets. This latter method was proposed by People's Counsel's witness in this case, but not accepted by the Commission which adhered to its long standing practice of adopting the lead-lag method.

The People's Counsel's witness proposal has been rejected for several reasons. First, it provides a "snapshot"

view of the utility which may or may not reflect normal conditions, whereas the lead-lag method represents a synthesis of the year's operations. Second, and more importantly, the so-called "balance sheet" approach selectively includes some non-utility, "below the line" items, *e.g.*, accrued interest and dividends, while excluding non-utility property and miscellaneous deferred debits. In short the balance sheet approach becomes significantly unbalanced. By contrast, the lead-lag study analysis is confined to the Company's utility operations, and affords a precise measurement of working capital needed to support those operations.

Under the "balance sheet" approach accrued taxes, interest and dividends are included among the current liabilities that are deducted from current assets to determine cash working capital. This is not a unique characteristic of the "balance sheet" method, however. A lead-lag study can be performed on a basis that takes these things into account, and indeed the lead-lag study used in this case does include an offset for the lag in payment of taxes. It does not take into account the lag in payment of accrued interest and dividends, however, because in this Commission's judgment interest and dividends, once accrued, lose their characteristic as customer supplied funds. This judgment, we believe, lies within our discretion to make.

Also well within our discretion is the decision as to the method to be used in calculating the working capital requirement. As stated, we believe that the lead-lag study used in this case properly states Potomac Electric Power Company's working capital requirements for its utility business. Having made this determination, we believe it improper to depart from the lead-lag approach by introducing, in part, elements of one of the other methods of calculating working capital. Were we to do so, the result would be a commingle of cash, accrual utility and non-utility items which would produce a number, but whether that number would have any relation to actual cash needs

to meet utility operating expense would be doubtful at best.

In fine, we decline the invitation to commingle elements of the balance sheet approach with the lead-lag approach, and will adhere to our prior practice as followed in this case.

People's Counsel also urges that customer deposits are a source of customer provided working capital to the company and should be deducted from rate base.

In our calculation of Potomac Electric Power Company's rate base in this case customer deposits are not included. Thus, the customer of Potomac Electric Power Company is not being required to pay the return on a rate base item which it has furnished without cost to the company.

Here again, as in the case of cash working capital, we have a question of regulatory philosophy. For in essence, People's Counsel suggests a commingling of rate base and capital structure items with the apparent objective of equalizing rate base and capital structure. The regulatory approach followed by almost all commissions, including this Commission, is the determination of the rate base without consideration of the dollar amounts in the capital structure accounts. Accounting entries do not govern, of course, rate making considerations; and even if desired, equality between rate base and capital structure accounts at any point in time may well be purely coincidence.

Among the factors influencing equality are, for example, whether analysis and determination should be made before or after jurisdictional separations, or before or after rate making adjustments, or before or after proposed new issues of stock or debt. Were we to reduce rate base by the amount of customer deposits, for which compensation at the rate of 7 percent is being paid by the investors should we not also include in capital structure and credit the investors with such items as debt discounts and accrued interest and dividends?

Inasmuch as we see no need to achieve equality between rate base and capital structure in order to reach a just and reasonable end result, we will as a matter of regulatory principle and practice deny People's Counsel's exception to our treatment of customer deposits.

People's Counsel also urges again the adjustment of revenues and expenses to reflect year end customer use where, as in this case, we have decided to use a year end rate base for plant in service. We have two problems with this contention. First, as noted in our Proposed Opinion and Order, we were unable to conclude that a simple mathematical calculation based on a snapshot view of operations at year end is or will be representative of future conditions. Second, the adjustment proposed by People's Counsel would effectively eliminate an allowance for attrition which is the very purpose for our use of year end rate base. For these reasons, then we will deny this exception filed by People's Counsel.

Having denied generally, and in particular, exceptions to our Proposed Opinion and Order, we hereby adopt that Opinion and Order, as supplemented herein, as our final decision in this proceeding. Accordingly, Potomac Electric Power Company is hereby authorized to file tariffs with this Commission in conformity with Attachment A hereto. These tariffs when filed shall be effective as to energy sold on and after December 16, 1976.

A TRUE COPY:

By the Commission:

/s/ RUTH HANKINS-NESBITT
Ruth Hankins-Nesbitt
Chairperson

Chief Clerk

APPENDIX C

PUBLIC SERVICE COMMISSION OF THE DISTRICT OF COLUMBIA

1625 I Street, N.W., Washington, D. C. 20006

Order No. 5856

February 14, 1977

IN THE MATTER OF

Application of POTOMAC ELECTRIC POWER COMPANY for an Increase in its Retail Rates for the Sale of Electric Energy	)	Formal Case No. 651

Order On Reconsideration

The Commission has for consideration four applications for reconsideration of its Order No. 5849, adopted December 16, 1976, in this case. These applications, filed by the AC/DC Committee, D.C. Department of Transportation (DOT), People's Counsel, and the Washington Public Interest Organization (WPIO) urge that Order No. 5849 be reconsidered and modified in the following respects:

1. Exempt from any rate increase the all-electric customer's basic rate for space-heating usage during the winter months (AC/DC Committee);
2. Stay the increase in rates for servicing street lights, pending separate hearing on this particular service (Department of Transportation);
3. Reduce the cash working capital allowance (People's Counsel); and

4. Find that gain from the appreciation of properties transferred out of public service should accrue to the benefit of ratepayers (WPIO).

Pepco, in opposing the applications, asserts that with the exception of DOT, the filing parties merely seek to reargue issues already briefed and argued before issuance of Order No. 5849. With respect to the DOT application, Pepco suggests that it be dismissed as untimely both as to the date of its filing* and as to its tardiness in bringing up the question of rates for servicing street lights for the first time by petition for reconsideration after issuance of the final order.

We are inclined to agree with Pepco's characterization of the AC/DC and WPIO applications as essentially rearguing positions first advanced during the hearings in this case and again argued on exceptions to our October 20, 1976 Proposed Opinion and Order (Order No. 5831). We are well aware of the all-electric customers' desire for lower rates, and of WPIO's position on the question of appreciation in property values. We see no purpose to be served by repeating here for a third time our reasons for remaining unpersuaded by the AC/DC and WPIO arguments, or for granting WPIO's request for further briefing and argument. We will therefore deny those applications and the request for the reasons given in Order Nos. 5831 and 5849.

We are also inclined to agree in principle with Pepco that People's Counsel's arguments with respect to cash working capital are "largely . . . a recapitulation of points . . .

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* We decline to dismiss the DOT application as untimely filed. The "Sunday-holiday" rule is an anachronism, reflecting a period when government offices were open on Saturdays. We believe we are required to afford applicants for reconsideration the full 30 day period allowed by statute, and where the 30th day falls on a day when our offices are closed and filing is therefore impossible, we will follow the general rule and consider timely a filing made on the next business day.

already discussed" in People's Counsel's exceptions to our Proposed Opinion and Order. People's Counsel's application does raise, however, one specific cash working capital point not addressed in our prior orders which merits discussion here. Without abandoning her position that Pepco's cash working capital allowance should have been determined on the basis proposed by witness Trawicki (the so-called "balance sheet" method), People's Counsel now asserts that the lead-lag study accepted by the Commission in this case was itself flawed by a failure to include all accrued taxes, specifically Federal and D.C. income taxes, as an offset to working capital.

The short answer to this assertion is that the use of a zero lag for income taxes is reasonable and does reduce the working capital allowance as compared to the methodology employed in prior decisions of this Commission. There was no accrual of D.C. income tax expense during the test year involved in this case and there was a negative charge of some $10 million for test year Federal income tax. This is clearly shown by comparison of Pepco's FPC Form 1 reports for the beginning and end of the 1975 test year.

It may be helpful once again to briefly summarize the essential elements and purpose of the lead-lag study approach to a cash working capital determination. As stated in Order No. 5849, a lead-lag study involves the netting of the lag in payment of operating expenses against the lag in receipt of utility revenues. Its purpose is to provide a precise calculation of the amount of money required by a utility to meet operating expenses incurred prior to the receipt of revenues from its customers. Electric utilities such as Pepco render bills for services only after those services have been furnished and the expenses involved in furnishing service (*e.g.*, payroll) have been incurred. Moneys needed to meet those expenses are called cash working capital.

In making a lead-lag study, therefore, a non-expense such as that found here, *i.e.*, no accruals for income taxes,

has no place. This is precisely the result of the use of zero lag for income taxes in this case.

In denying People's Counsel's application, we must also note in passing our adherence to our previously expressed view that it would be wholly improper to select parts of a lead-lag study and to engraft on that study parts of the balance sheet approach. This it seems we are again urged to do by People's Counsel's suggestion that "the magnitude of the working capital allowance is not co-extensive with the working capital requirement," the difference apparently being found in her witness' concept of investor supplied funds.

As we have previously pointed out, were we to accept the balance sheet theory, we would of necessity include all balance sheet items, such as non-utility property and deferred debits. Once again, we decline to selectively choose piece-parts of the different methodologies, an approach which depending on the selection could adversely affect either Pepco or its ratepayers, but which in either case would be, in our judgment, indefensible.

Turning next to the DOT application, we must acknowledge at the outset the correctness of DOT's assertion that the matter of rates for servicing street lights* was not the subject of discussion on the record of this case, nor was it addressed with any degree of specificity in testimony or exhibits. Pepco's December 29, 1975 application for authority to increase rates and its accompanying prepared testimony did in fact expressly state that no increase in rates for street lighting services was proposed.

Despite this disclaimer of intent on the part of Pepco, the Commission itself of course remained free to order any changes in Pepco's proposal that might better serve the

* This service, essentially an operating and maintenance function, should not be confused with the supply of electric energy for street lighting.

public interest; and any party to the case, including DOT, could have proposed such changes. The fact of the matter, however, is that on the record of this case the question of Pepco's charges for servicing street lights was not the subject of any recommendation or contention that Pepco's initial proposal should be changed. In this context, we note in passing that DOT's contention now that it can and will show, given opportunity for further bearing, that there should in fact have been a decline in costs associated with these services would more properly and more helpfully have been made during the course of the proceedings, rather than on application for reconsideration of our final order. Had this been done, the question could have been explored and resolved on the record, and the problem now before us would not have arisen.

We are nevertheless faced with the necessity for resolving this problem now, and we do not find its resolution to be a simple matter. To recapitulate the facts, we have a situation in which no increase in rates for this service was proposed by Pepco; there was no testimony of record on this point, nor was it addressed on brief or argument; inferentially, our Proposed Opinion and Order called for rate increases for servicing street lights in requiring a proportionate increase in all rates with three exceptions, of which electricity for street lighting was one but servicing was not; our Final Opinion and Order, Attachment A, specifically provided for rate increases for servicing street lights.

We must also acknowledge the fact that DOT, as an intervenor in this case, was entitled to participate fully as a party in the presentation of evidence, the cross-examination of witnesses, the filing of briefs, the presentation of oral argument, and the filing of exceptions to our Proposed Opinion and Order. DOT did not choose to avail itself of any of these rights. Under the circumstances, it is indeed tempting to say, as Pepco suggests, that we should

now "reward DOT for its lethargy and failure to protect what it belatedly perceives to be its best interest."

We have determined here, however, to resist this temptation. Our ratemaking proceedings are essentially legislative in nature rather than adversary; and our effort to best serve the public interest is enhanced, in our judgment, by assuring that the parties to our proceedings are given the fullest possible opportunity to make their views known to us. To do so, the parties must be fully aware of the issues before us for decision. We cannot say, on the record of this case, that DOT or any other party to this proceeding knew, or in the exercise of reasonable diligence should have known, that changes in the rates for servicing street lights were contemplated.

This is not to say that some of the evidence of record have, *e.g.*, evidence of increased labor costs, might not be as applicable to servicing street lights as to other classes of service. The connection, however, if there is one, was not made on the record and we decline to indulge in post-decisional rationalization of this kind on our own motion now. We are therefore of the opinion that on the record of this case, increases in rates for servicing street lights cannot be justified.

Having made this difficult decision, however, our problems are not fully resolved. The obvious potential effect of this decision is to reduce, by the amount of gross revenue calculated to result from these rate increases (approximately $891,000), the total amount of additional revenue that Pepco was to be allowed an opportunity to earn pursuant to our final Order ($29,411,000).

We perceive as available to us in this situation three possible alternatives: 1) stay the rate increases for servicing street lights—or permit their collection under bond and subject to refund—pending completion of a new hearing on the matter; 2) cancel these increases, and allow Pepco

to spread the potential revenue deficiency resulting from concellation among rates for other services; or 3) cancel these increases, subject to such further action as current or future circumstances may warrant.

The first of these alternatives, although perhaps the most obvious choice, has little if any appeal from either a practical or a legal standpoint. As a practical matter, it offers the promise of a somewhat lengthy hearing, involving infinite detail, which might very well in terms of time, effort and out-of-pocket expense cost the parties and the Commission almost as much as the amount involved. As a legal matter, consideration of revenues derived from one service necessarily impacts total revenues, with the result that a small beginning may result in a new overall Pepco rate proceeding. Inasmuch as there are now underway a number of studies (including street light burning hours) which may in the very near future suggest a number of changes in Pepco's rates, we would find it difficult to conceive of a less appropriate time to become involved in a new Pepco rate case.

As to the second alternative, we must note at the outset that we have found just and reasonable, less than two months ago, the rates currently in effect for Pepco's customers in the District of Columbia. For us to say that to be just and reasonable these rates must now be increased, albeit by very small amounts, would be most difficult to support. We entertain serious doubt that what might be termed a procedural error involving another rate could or would be considered adequate justification.

Additionally, we are strongly disinclined, under the circumstances currently existing with respect to street lighting rates, to further add to the burden being borne by the District of Columbia ratepayers.

In considering the third alternative, we must again keep in mind the on-going rate studies being made by Pepco, and the possibility of rate changes in the near future.

Additionally, we are persuaded that we must not close our eyes to the reported results of Pepco operations in recent months.* Moreover, as has often been said, ratemaking is not an exact science, and our ratemaking orders do not guarantee either the precise number of dollars in total revenue or the mathematically calculated rate of return specified in the order.

Relating these concepts to the facts before us suggests that it may indeed best serve the public interest here were we to adopt the third alternative. As we have noted, the gross amount involved appears to be approximately $891,000, a figure which, if earned, would produce approximately $396,000 in after tax net operating revenue to Pepco. Although the revenue, expense and return calculations contained in our Order No. 5849 are mathematically precise, it is a certainty that Pepco's actual operating results will vary from those amounts by some degree, and we cannot say that a variation to the degree represented by the relatively small amount here involved (slightly over 1% in terms of net additional revenue) would be unusual or unexpected.

In consideration of all of the circumstances, we are persuaded to adopt our third alternative. We will therefore require Pepco to cancel the increases imposed on servicing street lights, effective as of the issuance of this order, but without prejudice to any further action by the parties or by the Commission as may be warranted by the conditions then existing. We do most earnestly urge Pepco and DOT, however, as we have repeatedly over the past several years, to make every possible effort to resolve their differences, particularly in the area of servicing street lights, through mutual agreement.

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* Pepco's 1976 revneues were $549,971,000, up 12% from 1975; it earned $1.72 per share in 1976, compared to $1.16 in 1975; and it increased its quarterly dividend from $.29 to $.32.

In summary, then, we have in this order reviewed and denied the applications for reconsideration of our Order No. 5849 filed by AC/DC, People's Counsel, and WPIO, for the reasons stated. We have granted, to the extent and in the manner indicated, the application by DOT.

So ordered, this 14th day of February, 1977.

A TRUE COPY:

By the Commission:
/s/ RUTH HANKINS-NESBITT
Ruth Hankins-Nesbitt
Chief Clerk

Chairperson

MAJORITY OPINION BY:

Ruth Hankins-Nesbitt
Chairperson

H. Mason Neely
Vice Chairman

DISSENTING IN PART:

William R. Stratton
Commissioner

APPENDIX D

DISTRICT OF COLUMBIA COURT OF APPEALS

No. 11780

WASHINGTON PUBLIC INTEREST ORGANIZATION, ET AL., PETITIONERS

v.

PUBLIC SERVICE COMMISSION OF THE DISTRICT OF COLUMBIA, RESPONDENT,

WASHINGTON GAS LIGHT COMPANY, INTERVENOR.

No. 11786

PEOPLE'S COUNSEL, PETITIONER,

v.

PUBLIC SERVICE COMMISSION OF THE DISTRICT OF COLUMBIA, RESPONDENT,

WASHINGTON GAS LIGHT COMPANY, INTERVENOR.

No. 12017

WASHINGTON PUBLIC INTEREST ORGANIZATION, ET AL., PETITIONERS,

v.

PUBLIC SERVICE COMMISSION OF THE DISTRICT OF COLUMBIA, RESPONDENT,

POTOMAC ELECTRIC POWER COMPANY, INTERVENOR.

(Argued September 20, 1977 Decided September 12, 1978)

[2225]

Gilbert Hahn, Jr., for petitioners in Nos. 11780 and 12017.

Elizabeth A. Noel for petitioner in No. 11786.

Linus Deeny for respondents in Nos. 11780 and 11786.

James T. McManus, with whom *John R. Risher, Jr.*, Corporation Counsel, and *James T. McManus*, Principal Deputy Corporation Counsel, were on the brief, for respondent in No. 12017.

Paul H. Harrington, with whom *Lewis Carroll* was on the brief, for intervenor in Nos. 11780 and 11786.

Allen C. Barringer, with whom *Lewis Carroll* and *Alan G. Kirk* were on the brief, for intervenor in No. 12017.

Before NEWMAN, *Chief Judge*, and NEBEKER and FERREN, *Associate Judges*.

Opinion for the Court by *Associate Judge* FERREN.

Statement by *Associate Judge* NEBEKER at p. 51.

FERREN, *Associate Judge*: Petitioners, Washington Public Interest Organization (WPIO) and the People's Counsel, challenge the rate increases granted by the Public Service Commission of the District of Columbia (the Commission) to Potomac Electric Power Company (Pepco) and to Washington Gas Light Company (WGL) in October, 1976. Petitioners raise a single issue: when land no longer used in delivering service to the public is

sold by a public utility company, should the financial gain—representing appreciation of the property while in service, *i.e.*, while in the "rate base"—accrue to the company's shareholders or to its customers (in the form of reduced utility rates)?

The Commission ruled that the shareholders alone should benefit. Its decision rests primarily on the ground that allocation of appreciation on retired land to the shareholders conforms to the mandate of the standard accounting system for utility companies, *i.e.*, the Uniform System of Accounts promulgated by the Federal Power Commission and adopted by our own Commission for use in the District of Columbia.

This simple rationale belies a complex inquiry. After stating the facts and procedural history (Part I) and taking account of our scope of review (Part II), we explore (Part III.A.) the historical relationship between the uniform accounting system and ratemaking. After concluding, on the basis of a substantial body of case law, that the prescribed accounting treatment does not necessarily dictate a particular ratemaking result, we turn (Part III.B.) to the details of the uniform accounting system, in order to determine whether the Commission's per se reliance on it for ratemaking appears sound, even without an historical mandate. We conclude that the general principles of this accounting system, while intended to have ratemaking consequences, are subject to so many exceptions, and their application accordingly requires the exercise of so much Commission discretion, that the system itself is not selfjustifying as an automatic basis for a ratemaking decision. Finally, therefore, we consider (Part III.C.) the question whether application of the Uniform System of Accounts as the basis for ratemaking on the facts here can be said to pass

muster. We conclude that the Commission has not supplied enough facts, coupled with detailed enough reasoning, to justify treatment of the land transactions solely by reference to the Uniform System. Our only available course, therefore, is to remand the proceedings for clarification.

I. *Procedural History; Facts and Question Presented*

On December 29, 1975, Pepco filed an application with the Commission for a rate increase for retail electric service in the District of Columbia. As subsequently modified by Pepco, the requested increase would have totaled $57,578,000 annually. On October 20, 1976, after an eleven-day hearing in which WPIO, the People's Counsel, and four other parties participated as intervenors, the Commission issued a Proposed Opinion and Order (No. 5831) granting Pepco a 9.06% overall rate of return. This resulted in a total rate increase of $29,411,000 annually, amounting to slightly more than 50% of the increase requested. Subsequently, WPIO, the People's Counsel, and two of the intervenors filed exceptions and applications for reconsideration, all of which the Commission denied. Petitioner WPIO has filed for review by this court (case No. 12017).

On September 30, 1975, WGL filed with the Commission an application for a retail gas rate increase of $7.5 million annually. WPIO and the People's Counsel intervened. After a hearing, the Commission on October 29, 1976, issued a Final Opinion and Order (No. 5833) granting WGL a rate of return of 9.25%, resulting in an annualized rate increase totaling $6.7 million, almost 90% of the amount requested. Applications for reconsideration by WPIO and the People's Counsel were denied, whereupon they filed petitions for review by this court (case Nos. 11780 and 11786, respectively).

We have consolidated these three petitions for review.

As to Pepco, the parties have stipulated that during the ten-year period 1965-74: (1) the company received a net gain of $542,179.22 (*i.e.*, "the difference between book value and sale price on the date of sale") from 103 transactions involving the "sale of land which at some prior date had been classified as having been devoted to public service"; and (2) the company transferred " 'below the line' or out of public service" 18 sites for which the net gain (*i.e.*, "the difference between book value and market value on the date of transfer") was $182,390.33.[1] The parties also stipulated that of the total net gain of $724,569.55 from these sales and transfers, "$381,938.00 is allocable to Pepco's District of Columbia operations." Finally, the parties stipulated that in 1972, Pepco removed its 929 "E" Street, N.W. property "from [the] Utility Property [account] . . . as no longer used and useful." In this connection, they further stipulated that when Pepco sold the property in March, 1976, the net gain—the difference between market value and depreciated book value—was at least $468,324.06, of which at least $207,139.73 was allocable to District of Columbia operations. Accordingly, the parties have stipulated that the total net gain allocable to District of Columbia operations for the Pepco properties at issue is at least $589,077.73.

As to WGL, the parties have stipulated that during the period January 1, 1965, to February 29, 1976, the company received a net gain, before taxes, of $6,343,270 from "12 transactions representing the sale of land and

[1] The stipulations were agreed upon initially by WPIO and the utility companies, Pepco and WGL. The People's Counsel accepts the facts stipulated for purposes of their appeal in case No. 11786.

related improvements which at some prior date had been classified as having been devoted to public service." (The breakdown between depreciable improvements and non-depreciable land is provided only for certain Georgetown properties sold during the test year ending April 30, 1975).

Each case presents the question whether, in granting the particular rate increase, the Commission improperly failed to credit the customers—the ratepayers—with the stipulated gains received by Pepco and WGL, respectively, upon disposition of land removed from each company's utility service operation. This question arises, to put it most simply, as follows: In accordance with the Uniform System of Accounts prescribed by the Federal Power Commission (FPC) and adopted by the Public Service Commission of the District of Columbia, the gains and losses from dispositions of property owned by utility companies are allocated, depending on the circumstances, either to the customer-ratepayers (called "above the line" treatment) or to the investor-shareholders (described as "below the line"). *See* J. SUELFLOW, PUBLIC UTILITY ACCOUNTING: THEORY AND APPLICATION 23-24 (1973) (hereinafter "SUELFLOW"). According to this accounting system—and subject to notable exceptions—dispositions of land previously retired from active use in utility service are usually accounted for "below the line"; shareholders alone benefit—or lose—from each transaction through an increase or decrease in the corporate earned surplus account. Dispositions of retired depreciable plant facilities, on the other hand, are usually accounted for "above the line"; typically, the ratepayers stand to benefit—or lose—in the calculation of the rates they are required to pay. *See* Part III.B., *infra*.

The justification for such accounting principles, with their impact on utility rates, is generally based on the

proposition that the ratepayers, who have been charged for depreciation of plant facilities, should be repaid with the gains, if any, upon eventual sale of those facilities. Because land is not depreciable, however, and the ratepayers accordingly have not been responsible for replenshing it, the gains, if any, on sales of retired land are left to the investor-owners. They are the ones, at least theoretically, who brought the land to the enterprise and, as a result, should benefit.

Necessary refinements of these general principles will be discussed in due course. Suffice it to say at this point that petitioners challenge the Commission's decision to apply the uniform accounting system here, such that the land dispositions receive "below the line" treatment. More particularly, WPIO has asked that gains accruing to Pepco on land retirements and dispositions during the ten-year period, 1965-74, be credited to ratepayers in at least the amount of the $589,000.00 allocable to District of Columbia operations (presumably less taxes), and that gains accruing to WGL over an eleven-year period, January 1, 1965, through February 29, 1976, be allocated to ratepayers in the amount of at least $6,343,000, less taxes. (Presumably this figure, as in the Pepco case, should be reduced to reflect gains allocable to the District of Columbia.) The People's Counsel, however, asks for a credit of $2,976,217 to WGL ratepayers, limiting its request to after-tax gains during WGL's "test year" ending April 30, 1975.[2]

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[2] The "test year" or "test period" is a "span of time in the immediate past" used as the basis for making a forecast of the utility company's financial needs, *i.e.*, for calculating its essential rate of return. *Telephone Users Ass'n v. Public Service Comm'n*, D.C.App., 304 A.2d 293, 297 (1973), *cert. denied*, 415 U.S. 934 (1974). *See* J. BONBRIGHT, PRINCIPLES OF PUBLIC UTILITY RATES, 150 n.7 (1961).

II. *Scope of Review*

A. *In General*

The Commission, not this court, has the responsibility for setting utility rates. D.C. Code 1973, §§ 43-301, -401, -411. To be lawful, however, these rates must be "reasonable, just, and nondiscriminatory." D.C. Code 1973, § 43-301. They are subject, accordingly, to judicial review.[3]

This court has "jurisdiction to hear and determine any appeal from an order or decision of the Commission." D.C. Code 1973, § 43-705. *See* D.C. Code 1973, § 11-722. Our review, however, is "limited to questions of law, including constitutional questions; and the findings of fact by the Commission shall be conclusive unless it shall appear that such findings of the Commission are unreasonable, arbitrary, or capricious." D.C. Code 1973, § 43-706. *See Apartment House Council of Metropolitan Washington v. Public Service Comm'n*, D.C.App., 332 A.2d 53 (1975); *Chesapeake & Potomac Telephone Co. v. Public Service Comm'n*, D.C.App., 330 A.2d 236 (1974); *Goodman v. Public Service Comm'n*, D.C.App., 309 A.2d 97 (1973); *Telephone Users Assn' v. Public Service Comm'n*, D.C.App., 304 A.2d 293 (1973), *cert. denied*, 415 U.S. 933, 934 (1974).

These statutory criteria are akin to those governing the Federal Power Commission and its oversight by the federal courts. In that context, the Supreme Court has held that unless the overall effect of a rate is "unjust and

[3] This case does not concern allegations of discrimination against one or more classes of users under the rate schedule. *See Apartment House Council of Metropolitan Washington v. Public Service Comm'n*, D.C.App., 332 A.2d 53 (1975). Accordingly, we confine our discussion to an evaluation of whether the rates at issue are reasonable and just.

unreasonable," the Commission's order should be approved, irrespective of "infirmities" in the methodology used to calculate it. *Federal Power Comm'n v. Hope Natural Gas Co.*, 320 U.S. 591, 602 (1944). *See Federal Power Comm'n v. Natural Gas Pipeline Co.*, 315 U.S. 575, 585-86 (1942). It follows that a rate order, as "the product of expert judgment," is presumptively valid; it should be upheld unless a petitioner makes a "convincing showing" that it fails to meet the statutory criteria. *Federal Power Comm'n v. Hope Natural Gas Co.*, *supra* at 602. *See Apartment House Council of Metropolitan Washington v. Public Service Comm'n*, *supra* at 56.

Given the Commission's broad statutory authority, our own limited scope of review, the judicial emphasis on the reasonableness of the overall rate (irrespective of Commission methodology), and the petitioner's burden to make a "convincing showing" of unreasonableness, one might conclude that the Commission's authority is virtually plenary. Not so. While the reviewing court cannot mandate a particular rate, and can only set aside a rate order upon a "convincing showing" of unreasonableness, the court, when presented with a nonfrivolous petition for review, has a responsibility to hold the Commission accountable—through as many remands as necessary—for satisfying a burden all its own: to explain its actions fully and clearly. A utility rate cannot be deemed "reasonable" simply because an expert agency says it is. Independent of a petitioner's burden to show convincingly that a Commission-prescribed rate is unreasonable, the Commission—as we shall develop below—has the burden of showing fully and clearly why it has taken the particular ratemaking action. Absent such comprehensive explanation, judicial review of the Commission's substantive decisions cannot be completed and the rate order finally approved—or set aside.

There are two aspects of this elaboration required of the Commission: (1) announcement of the criteria governing the rate determination, and (2) explanation of how the particular rate order reflects application of these criteria to the facts of the case. More particularly, as to the first, any valid rate determination presupposes that the Commission has selected suitably precise criteria by which "reasonableness" of the order can be judged.

> Although neither law nor economics has yet devised generally accepted standards for the evaluation of rate-making orders, it must, nonetheless, be obvious that *reviewing courts will require criteria more discriminating than justice and arbitrariness if they are sensibly to appraise the Commission's orders.* [*Permian Basin Area Rate Cases*, 390 U.S. 747, 790 (1968) (footnote omitted; emphasis added).][4]

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[4] The Supreme Court has elaborated three "interrelated criteria" for judicial review which incorporate commission-type criteria for reasonableness:

> First, it must determine whether the Commission's order, viewed in light of the relevant facts and of the Commission's broad regulatory duties, abused or exceeded its authority. Second, the court must examine the manner in which the Commission has employed the methods of regulation which it has itself selected, and must decide whether each of the order's essential elements is supported by substantial evidence. Third, the court must determine whether the order may reasonably be expected to maintain financial integrity, attract necessary capital, and fairly compensate investors for the risks they have assumed, and yet provide appropriate protection to the relevant public interests, both existing and foreseeable. The court's responsibility is not to supplant the Commission's balance of these interests with one more nearly to its liking, but instead to assure itself that the Commission

> has given reasoned consideration to each of the pertinent factors. [*Permian Basin Area Rate Cases, supra* at 791-92.]

This need for explicit criteria follows from the fact that in each case there will be a "zone of reasonableness," *Federal Power Comm'n v. Natural Gas Pipeline Co., supra* at 585, with boundaries which the Commission must define and apply. *See Washington Gas Light Co. v. Baker*, 88 U.S.App.D.C. 115, 119, 188 F.2d 11, 15 (1950), *cert. denied*, 340 U.S. 952, *appeal after remand*, 90 U.S.App.D.C. 98, 195 F.2d 29 (1951). From the investor standpoint, the lower boundary—the floor of that zone—has already been defined by the courts in constitutional terms and remains only to be applied in each case. "By long standing usage in the field of rate regulation, the 'lowest reasonable rate' is one which is not confiscatory in the constitutional sense." *Federal Power Comm'n v. Natural Gas Pipeline Co., supra* at 585. From the consumer standpoint, the upper boundary—the ceiling—is less well defined, although it is clear that "[t]he consumer interest cannot be disregarded in determining what is a 'just and reasonable' rate . . .," *id.* at 607 (Black, Douglas, and Murphy, JJ., concurring), and the rate itself cannot be "exorbitant." *Washington Gas Light Co. v. Baker, supra* at 119, 188 F.2d at 15. Equitable factors from the ratepayer perspective, therefore, are equally a part of the just and reasonable rate calculus. *See Permian Basin Area Rate Cases, supra* at 791-92; *Democratic Central Committee v. Washington Metropolitan Area Transit Comm'n*, 158 U.S.App.D.C. 7, 485 F.2d 786 (1973), *cert. denied*, 415 U.S. 935 (1974) (*"Democratic Central Committee I"*). In summary, the Commission's responsibility begins with development and announcement of criteria circumscribing the "zone of reasonableness."

Second, and of equal importance, the Commission has a duty to explain clearly how its criteria are satisfied by the rate order—how it arrived at the particular result. As the Supreme Court has noted:

> Judicial review of the Commission's orders will . . . function accurately and efficaciously only if the Commission indicates fully and carefully *the methods by which*, and the purposes for which, it has chosen to act . . . . [*Permian Basin Area Rate Cases*, *supra* at 792; emphasis added.]

While it is true that a regulatory commission cannot be faulted for its methodology if the "total effect of the rate order cannot be said to be unjust and unreasonable," *Federal Power Comm'n v. Hope Natural Gas Co.*, *supra* at 602, it is also true that the methodology must be disclosed for the bearing it may have on that overall judgment. Absent precise explanation of methodology as applied to the facts of the case, there is no way for a court to tell whether the Commission, however expert, has been arbitrary or unreasonable.

This Supreme Court emphasis on creation of reasonably precise ratemaking criteria, coupled with a duty to explain with clarity how the facts relate to each in support of the overall rate order, is inherent in the Commission's responsibilities under the District of Columbia Administrative Procedure Act ("DCAPA"), D.C. Code 1978 Supp., §§ 1-1501 *et seq.*, by which a rate order also must be tested.[5] This statute specifies the burden imposed on

[5] We have held that the DCAPA applies to actions of the Commission, subject to provisions of the organic act setting forth our scope of review, D.C. Code 1973, §§ 11-722, 43-706, and requiring a petitioner to seek reconsideration by the Commission, D.C. Code 1973, § 43-704, prior to petitioning for judicial review. *Chesapeake & Potomac Tel. Co. v. Public Service Comm'n*, D.C.App., 339 A.2d 710, 713 n.12, 714 (1975).

each party to an administrative proceeding, as well as the burden on the agency itself. More particularly, "the proponent of a rule or order shall have the burden of proof." § 1-1509(b). In the present case, therefore, Pepco and WGL have the burden, at the Commission level, of establishing that their proposed rate orders are just and reasonable, including the allocations of gains (and losses) on land transactions inherent in their proposed ratemaking methodology. Included in that burden is a responsibility to develop a record sufficiently complete to support a Commission order in their favor on any contested issue. In contrast, WPIO and People's Counsel have no formal burdens. To prevail, however, they must defeat the utility companies with evidence and/or argument on the land-gains issue. The Commission, as decision-maker, must evaluate all the presentations and then fashion the most just and reasonable order, including a determination of the land-gains issue. The Commission, however, cannot validly do so without furnishing detailed findings of fact and conclusions of law sufficient to demonstrate that the overall rate determination is "in accordance with the reliable, probative, and substantial evidence." D.C. Code 1978 Supp., § 1-1509(e). *Chesapeake & Potomac Tel. Co. v. Public Service Comm'n*, D.C.App., 339 A.2d 710, 714. *See Telephone Users Ass'n v. Public Service Comm'n of D.C.*, *supra*.

This "substantial evidence" test is not directed solely at the quantity of evidentiary support for an administrative determination.[6] Equally important is the preceding language of § 1-1509(e), "*in accordance with* . . . ."

[6] As to the quantity requirement, 'substantial evidence" is " 'more than a mere scintilla' "; it is " 'such relevant evidence as a reasonable mind might accept as adequate to support a conclusion.' " *Vestry of Grace Parish v. Alcoholic Bev. Cont. Bd.*, D.C.App., 366 A.2d 1110, 1112 (1976) (citation omitted).

[Emphasis added.] There "must be a *demonstration* in the findings of a 'rational connection between facts found and the choice made' [citation omitted]." *Brewington v. Bd. of App. and Rev.*, D.C.App., 299 A.2d 145, 147 (1973) (emphasis in original). *See Jameson's Liquors, Incorporated v. Alcoholic Bev. Cont. Bd.*, D.C.App., 384 A.2d 412, 418 (1978); *Kopff v. Alcoholic Bev. Cont. Bd.*, D.C.App., 381 A.2d 1372 (1977); *Deitrich v. Bd. of Zoning Adjustment*, D.C.App., 293 A.2d 470 (1972). Thus, as applied to ratemaking, there must be enough evidence, rationally related to the rate order (through clearly articulated criteria), to justify the Commission's decision.

The Commission's DCAPA obligation to justify its decisions on the basis of substantial evidence creates the possibility that a petitioner for judicial review of a Commission's rate order may fail to carry its burden to show convincingly that the Commission action is invalid; and yet the court cannot uphold the Commission itself because of its failure to satisfy the substantial evidence test. The Commission's failure may be attributable to the utility companies' own failure, as proponents of the order, to supply a sufficient quantity of evidence in support; or the Commission's failure may be due solely to its insufficient explanation of the reasonableness of the order. In either event, a remand will be necessary.

This possibility that neither petitioner nor Commission can prevail, for the time being, becomes clear when we focus more precisely on why courts remand administrative proceedings. In many cases, perhaps most, where a court remands after judicial review, the court can reach the merits because the agency has sufficiently articulated the reasons for its actions. When the court remands such a case, it holds that the action is substantively defective—is facially arbitrary or otherwise unsupported. In short, the

petitioner prevails. In other cases, however, the court—in finding a lack of substantial evidence—does not reach the merits because the agency's articulation of its position is too cryptic. The petitioners for judicial review have carried their burden to the extent of convincing the court that their position is not frivolous—they may have a valid point—and that the agency has not marshalled substantial evidence in support of its decision; but they have not carried their ultimate burden of convincing the court that the agency action cannot be supported. The principal reason why such petitioners may succeed in meeting this threshold burden, but not the ultimate one, is that the agency has given them a fuzzy target—one not sufficiently in focus to shoot at with careful aim. *See D.C. Transit Systems, Inc. v. Washington Metropolitan Area Transit Comm'n*, 121 U.S.App.D.C. 375, 401-2, 350 F.2d 753, 779-80 (1965) (en banc) (Commission failed to provide "an adequate basis for knowing why it did what it did").

A ratemaking proceeding is perhaps the most likely candidate for this latter type of result upon judicial review. A petitioner's burden is especially heavy to upset a rate order on the merits; thus, a reviewing court must be cautious before overturning an expert agency's determination. On the other hand, because ratemaking is complicated and understandably prone to technical, often shorthand terminology, there is a substantial risk that agency action will be too conclusional—not elaborated enough—for a non-expert court confidently to review. A court, without insisting on more precise explanation, could simply be fooled into accepting arbitrary agency action by the mesmerizing influence of the confidently expressed language of experts.

The requirement that a petitioner make a "convincing showing" to prevail on judicial review, therefore, wholly

compatible with the DCAPA requirement that the Commission, to be upheld, must demonstrate support of its order by substantial evidence. These independent burdens in the ratemaking context are derived, respectively, from a petitioner's traditional burden at the level of judicial review and the Commission's statutory burden to provide sufficient evidence to support its decision. It would be wholly at odds with the concept of judicial review to close a rate case in the Commission's favor, upon an insufficient showing by a petitioner, when the Commission's own order, under the guise of expertise, may preclude effective attack by inadequately explaining what the Commission has done and why the evidence supports it.

In summary, whereas a Commission rate order cannot be set aside unless a petitioner makes a "convincing showing" that it is unreasonable, unjust, or discriminatory, D.C. Code 1973, § 43-301, the same rate order cannot be approved by the reviewing court, without remand for clarification, unless—and until—the Commission has complied with the DCAPA by specifying its criteria for the order and clearly explaining, without material gaps, how its findings rationally support that determination. Perhaps paradoxically, therefore, the less equipped the court is to do the job of the agency, and thus the more deference the reviewing court must show to the agency's authority and expert judgment, the greater the agency's obligation is to explain exactly why it chooses to take a particular course of action. The broad scope of an agency's authority is the very reason why that agency is obliged to explain itself with precision. If such broad authority implied, to the contrary, that the agency need not explain itself, or could do so in shortcut fashion, then judicial review would be a nullity. While

our own authority to intrude on agency functions is therefore limited, our authority—and responsibility—to find out why an agency acts as it does is considerable.

B. *Review of an Element of the Rate Order*

While the ultimate issue, upon judicial review, is the overall effect of the rate order, this is not to say that our review must encompass all aspects of that order. In the present case, for example, the overall rate of return is not directly at issue. None of the petitioners questions the rate levels, as such, granted WGL and Pepco; all agree (or do not contest) that for District of Columbia operations WGL is entitled to a 9.25% overall rate of return each year, while Pepco is entitled annually to 9.06% overall. The narrow question, therefore, is whether a portion of each company's prescribed return should be deemed already paid by the realization of gain (or appreciation in value) on land no longer in service, entitling the customers to a short-term credit of some sort; or whether, instead, each company's return should be recoverable in full from charges to its customers. Thus, we are asked to limit our review to scrutiny of the Commission's expert judgment applied to but one of many elements of the ratemaking calculus.

While we can—and will—do so, we confront a possible problem of myopia. Assume that petitioners do reveal an apparent infirmity in the Commission's ratemaking here. How can we be sure that other aspects of the rate order do not compensate the class represented by petitioners for that infirmity, such that the overall effect of the order is just and reasonable? We note, for example, that a challenge to another aspect of the same 1976 Pepco rate order is pending before another division of this court, No. 12023; thus, we are not dealing with the only element

of that order that could undergo revision, affecting the parties' respective positions.

Our only choice, realistically, is to assume that respondents, aware of the overall effect or "end result" test, *Permian Basin Area Rate Cases*, *supra* at 791, will reveal any such compensating factor. It follows that petitioners would be obliged to refute the point as part of their burden to make a "convincing showing" of unreasonableness. In this case, however, it is fair to say that respondents have not proffered a compensating factor from Case No. 12023 or otherwise; thus, we can consider the record before us as the entire universe for review purposes, without concern that a vital portion of the rate proceeding transcript is missing or that we have not been provided with an additionally relevant interpretation of the data.

The logical extension of our position is this: whenever more than one petition for review of a Commission rate order is filed with this court, and the Commission or another party—in advocating the overall effect or "end result" test—concludes that the petitions should be consolidated to achieve the requisite perspective, the Commission or other party must assume the burden of filing a motion to that effect. It will be freely granted absent unusual circumstances. Without such consolidation, however, any division of the court will have to disregard the issues in the other pending case and evaluate the rate order with respect to the one or more elements presented.

We turn now to what the Commission has done—and why. We focus on the relationship between rate making and the Commission's prescribed accounting system for utility companies.

III. *The Uniform System of Accounts*

A. *Historical Relationship to Ratemaking*

The FPC initially promulgated uniform accounting systems in 1937 and 1940 for electric utility and natural gas companies, respectively. *See* Kripke, *A Case Study in the Relationship of Law and Accounting: Uniform Accounts 100.5 and 107*, 57 HARV. L. REV. 433, 435 (1944). It did so out of a concern about the difficulty of determining the true value of utility properties allowed to comprise the rate base. During the 1920s, a period of rapid turnover and consolidation of ownership, regulatory commissions were confronted by accelerating inflation of book costs as utility properties continually changed hands —sometimes at arm's length but often in transactions between affiliates at prices designed to maximize the share at the top of the corporate pyramid. *See Duke Power Co. v. Federal Power Comm'n*, 130 U.S.App.D.C. 389, 393, 401 F.2d 930, 934 (1968). In many cases, therefore, the purchase prices—and, consequently, the rate bases—for utility properties were derived from book values reflecting the capitalization of hopes (more commonly characterized as "water"). Accordingly, corresponding to an approach taken by the Federal Communications Commission (FCC) a few years earlier in 1935, the FPC's new system divided utility property book values into three categories: (1) the "original cost" of the property to the first company that devoted it to public service; (2) an "acquisition adjustment" account reflecting the difference between the utility's own acquisition cost and the depreciated original cost of the property; and (3) any further appreciation reflected in "writeups" by the company over the sum of the first two categories. *Kripke*, *supra* at 436.

At the time these accounting rules were promulgated, utility companies were entitled to a financial return (called "fair value") computed on a rate base utilizing reproduction costs, which commonly combined all three of the FPC categories. *See, e.g., The Minnesota Rate Cases*, 230 U.S. 352, 454-55 (1913); *Willcox v. Consolidated Gas Co.*, 212 U.S. 19, 41, 52 (1909); *Smyth v. Ames*, 169 U.S. 466, 546-47 (1898). Justice Brandeis, however, dissenting in *Southwestern Bell Tel. Co. v. Public Serv. Com'n*, 262 U.S. 276, 289 (1923), had attacked the reproduction cost approach, arguing that investors should be entitled only to a return on the capital prudently invested in the enterprise, not on the appreciating value of the property acquired. Utility companies understandably feared, therefore, that the FPC's uniform accounting system, by segregating cost data, presaged an effort to contract each utility's rate base from reproduction costs to original cost.

The regulatory agencies sought to avoid judicial scrutiny of their new accounting systems by insisting that these systems would not be considered conclusive for ratemaking purposes. The Supreme Court accepted such assurances, holding in *American Tel. & Tel. Co. v. United States*, 299 U.S. 232 (1936), that FCC accounting did not violate due process because it merely was a system of notation, without substantive significance.[7] In reaching

[7] By 1950, the FPC could announce that the reclassification of accounts initiated by promulgation of the Uniform System of Accounts had been substantially completed. FPC, REPORT ON RECLASSIFICATION AND ORIGINAL COST OF ELECTRIC PLANT OF PUBLIC UTILITIES AND LICENSEES (1950). From the books of electric utilities alone, the FPC eventually ordered the removal of $1.6 billion in excess of the original costs of plants out of $8.4 billion previously recorded in utility plant accounts. FPC ANNUAL REPORT (1965).

this conclusion, however, the Court was not oblivious to the powerful influence that the regulatory commissions' accounting systems inevitably would have on ratemaking. In fact, two years before the *American Tel. & Tel. Co.* decision, the Court already had recognized the significance of the accounting system for the rate structure. In *Lindheimer v. Illinois Bell Telephone Co.*, 292 U.S. 151 (1934), the Court had held that annual depreciation charges were properly limited to computations based on original cost rather than reproduction cost. Greater charges for depreciation, the Court had said, would be tantamount to capital contributions. *Id.* at 169.

By the 1940s, the Supreme Court was ready to allow federal regulatory agencies to utilize the new accounting systems, as the utility companies had feared, to abandon the "fair value" doctrine of ratemaking. In the spirit of Justice Brandeis' dissent in *Southwestern Bell Tel. Co., supra*, the Supreme Court held that utility investors—while entitled to a fair rate of return on the historical cost attributable to their capital investment—have no constitutional entitlement to a return on the increased value, if any, represented by reproduction cost over original cost. *Federal Power Comm'n v. Hope Natural Gas Co., supra; Federal Power Comm'n v. Natural Gas Pipeline Co., supra.* Consequently, the FPC and state regulatory commissions received for the first time a green light for rate orders based solely on historical costs.

These cases, however, went further than mere justification of historical cost-based rates. Their principal significance lies in two broader departures from previous holdings: (1) the Court shifted away from a focus on particular property values and rates of return to a more general, limited concern about "the financial integrity of the company whose rates are being regulated." *Federal*

Power Comm'n v. Hope Natural Gas Co., supra at 603; and (2) the Court emphasized granting considerable deference to the expertise of a regulatory commission in arriving at a proper ratemaking judgment. As a constitutional matter, according to three concurring Justices,

> [i]rrespective of what the return may be on "fair value," if the rate permits the company to operate successfully and to attract capital all questions as to "just and reasonable" are at an end so far as investor interest is concerned. Various routes to that end may be worked out by the expert administrators charged with the duty of regulation. It is not the function of the courts to prescribe what formula should be used. The fact that one may be fair to investors does not mean that another would be unfair. The decision in each case must turn on considerations of justness and fairness which cannot be cast into a legalistic formula. The rate of return to be allowed in any given case calls for a highly expert judgment. That judgment has been entrusted to the Commission. There it should rest. [*Federal Power Comm'n v. Natural Gas Pipeline Co., supra* at 607 (Black, Douglas, and Murphy, JJ., concurring).]

The Supreme Court, therefore, by the early 1940s, had shifted the utility investor's constitutional right from a just and reasonable rate of return based on current "fair value" of particular assets to a rate of return on an original cost rate base, with the particular rate being justified by the regulatory commission's expert view of the company's needs. A commission need only assure the "financial integrity" of the enterprise, including an ability to attract capital and compensate its investors for the risk assumed, even though the approved rate may "pro-

duce only a meager return on the so-called 'fair value' rate base." *Federal Power Comm'n v. Hope Natural Gas Co., supra* at 605.

In facilitating this transition from the "fair value" to the "financial integrity" approach, the Uniform System of Accounts did not become a sacred premise for ratemaking. Although the System had provided the mechanism for accomplishing a rejection of the "fair value" doctrine, it was clear all along, as enunciated in *American Tel. & Tel. Co., supra*, that accounting decisions, as such, could not be considered determinative for ratemaking itself. *See United States v. New York Telephone Co.*, 326 U.S. 638, 653 (1946); *Colorado Interstate Gas Co. v. Federal Power Comm'n*, 324 U.S. 581, 608 (1945); *Northwestern Electric Co. v. Federal Power Comm'n*, 321 U.S. 119, 125 (1944); *American Power & Light Co. v. Securities and Exchange Comm'n*, 158 F.2d 771 (1st Cir. 1946), *cert. denied*, 331 U.S. 827 (1947).

In our own jurisdiction, for example, there is significant precedent demonstrating that circumstances will dictate ratemaking judgments independent of the uniform accounting system. For example, in *Re D.C. Transit System, Inc.*, 30 P.U.R.3d 405, *aff'd*, 110 U.S.App.D.C. 241, 292 F.2d 734 (1961), the Commission's predecessor, the District of Columbia Public Utilities Commission (PUC), abandoned the normal accounting treatment when D.C. Transit System, Inc. sold its Fourth Street shops and Southern carhouse to the Redevelopment Land Agency. If the $1.921 million of the sales proceeds attributable to depreciable property had been credited to the depreciation reserve, as required by the Uniform System of Accounts, that reserve would have swollen to 180% of the original cost of the properties. The PUC accordingly deviated from the accounting rules by allowing the company to

credit to earned surplus the amount by which the proceeds attributable to the depreciable property exceeded the original cost.[8] The PUC noted:

> While fully cognizant of the desirability of adhering to the Uniform System of Accounts under normal conditions, we have never recognized the Uniform System of Accounts as an inflexible code from which departures in special or unusual circumstances would not be permitted when authorized by the commission. [*Id.* at 410.]

See Democratic Central Committee I, supra at 40-41, 485 F.2d at 819-20. There have been instances where the FPC, too, has rejected strict application of the uniform accounting rules in ratemaking proceedings. *Manufacturers Light & Heat Co.*, 44 F.P.C. 314, 321-25, *rehearing denied*, 44 F.P.C. 1138 (1970) (contrary to uniform accounting rules, FPC granted "above the line" recognition of gains and losses in company's reacquisition of debt securities); *United Gas Pipe Line Co.*, 31 F.P.C. 1180, 1189 (1964) (contrary to uniform accounting rules, FPC allowed "above the line" treatment of reasonable charitable contributions as an operating expense).

It thus appears that there is no mandatory relationship between the Uniform System of Accounts and the Commission's ratemaking. We must therefore examine the details of the System to determine whether the Commission's per se reliance on it for ratemaking, as a matter of expert judgment, would appear, nonetheless, to be sound.

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[8] Consistent with the Commission's position in the present case, the PUC agreed that the $.950 million profit on the sale of land was properly credited to earned surplus.

B. *Details of the Uniform System of Accounts: Implications for Ratemaking*

A regulated company's balance sheet segregates the "utility plant" assets (including land), which are "used and useful" in serving the public, from the company's other assets—called "nonutility property"—which are carried on the books, most commonly, as investments. SUELFLOW, *supra* at 25-31.[9] Similarly, the company's income statement carefully separates "utility operating income" and related expenses from its "other income" arising out of activities beyond the Commission's jurisdiction. *Id.* at 20-25. Gains and losses on "utility" operations generally are allocated "above the line" to the ratepayers, whereas "nonutility" gains and losses are allocated "below the line" to the investors. *Id.* at 23-24. In a sense, therefore, each public utility is at least two companies: one serving and accountable to the public (through the good offices of the Commission) and the other accountable solely to its investors.

These allocations either to ratepayers or to investors are implemented on the company's books through use of accounts established under the Uniform System to reflect transactions with specified consequences above or below the line. Fundamentally, therefore, a utility's accounting system is designed to channel entries into accounting categories intended to have a prescribed impact on periodic ratemaking. *Id.* at 24.

When the Uniform System of Accounts is carefully examined, three characteristics having a bearing on this

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[9] Utility plant assets (minus accrued depreciation) comprise the "rate base" on which the allowable rate of return is taken, whereas nonutility property is by definition placed outside the customers' obligation to provide a return. *See Telephone Users Ass'n v. Public Service Comm'n, supra* at 297, n.6.

case became apparent. First, when property owned by a utility company is sold, the System does not generally favor either the shareholders or the ratepayers; the System allocates gains (or losses) to one group or the other, depending on specified circumstances. Second, there are a number of significant exceptions to the allocation principles themselves, making generalizations even more difficult. Third, the System calls for the exercise of substantial discretion by the regulatory commission in determining whether a particular transaction is better characterized one way or another under the System, often with significant consequences above or below the line. Given respondents' substantial reliance on this accounting System as a basis for ratemaking, it is crucial to understand the extent to which the System's fixed principles, subject to various exceptions, applied with the Commission's discretionary hand, can be said to provide a coherent defense to petitioners' assertions.

There is a threshold distinction in the System between utility property that is "operating" and "nonoperating." When a utility's "operating unit or system" is sold, the gain or loss [10] on both plant and land is allocated "below the line" to the shareholders—"[u]nless otherwise ordered by the Commission." [11] Usually, therefore, the only

[10] Gain or loss is derived from the sale price, less expenses, taken against depreciated book cost.

[11] Plant Inst. 5.F., Uniform System of Accounts For Public Utilities and Licensees, (Class A and Class B), 18 C.F.R. Part 101 (1977); Plant Inst. 5.F., Uniform System of Accounts For Natural Gas Companies, 18 C.F.R. Part 201 (1977). These two systems applicable, respectively, to electric and gas companies are virtually identical and hereafter will be cited together solely as Definition ("Def."), General Instructions ("Gen. Instr."), Plant Instructions ("Plant Instr."), or "Accounts," as applicable.

benefit to the ratepayers is removal of the residual book value of the facility from the rate base.

Whenever utility property becomes "nonoperating," however (*i.e.*, it is "retired" from active service rather than sold as an operating facility), the accounting becomes more complex—sometimes to the ratepayers' benefit. If the property is merely transferred out of the rate base but retained by the company as "nonutility" property, the ratepayers receive the benefit of removal from the rate base—the same benefit they would have received if the property instead had been sold as an operating unit. Account 121. Thereafter, if this "nonutility" property is sold, all gains or losses on both land and depreciable plant facilities accrue to the shareholders. Accounts 421.1 and 421.2; Plant Instr. 7.E., 10.1. If, on the other hand, nonoperating utility property is sold immediately upon its retirement, without prior transfer out of the rate base to a "nonutility" account, all proceeds allocable to the sale of land will accrue—gain or loss—to the shareholders; but, contrary to the results when "operating" or "nonutility" property is sold, all proceeds of the depreciable plant facility upon "retirement" will be allocated to the ratepayers. Account 108, Plant. Instr. 10.B., 10.F. Thus, if the net "salvage" value of the electric or gas plant facility exceeds depreciated book costs, ratepayers will gain from the transaction. *But see In re D.C. Transit System, Inc.*, *supra* (discussed in Part III.A., *supra*). Otherwise, of course, ratepayers will break even or lose.[12]

In summary, under the general accounting rules applicable to dispositions of land (in contrast with de-

[12] "Salvage value" is defined as "the amount received for property retired, less any expenses incurred in connection with the sale or in preparing the property for sale." Def. 30. *See* SUELFLOW, *supra* at 92.

preciable plant facilities), gains or losses are not credited or charged to the ratepayers under any circumstance. Whether land is sold as part of an operating unit, or sold immediately upon retirement from service, or sold after transfer to the status of "nonutility" property, the Uniform System of Accounts generally provides that the shareholders alone shall benefit from any gain—and bear any loss.

These general rules, however, are subject to a number of significant exceptions. For example, as an incentive for utility companies to acquire—indeed to stockpile—land (or to retain retired land) for "future use" as the need may arise, the Uniform System permits a utility company to add such land to the rate base, even though it may never be used in service. Account 105. There is, nevertheless, a *quid pro quo* for the ratepayers. Upon disposition of land held in this account, all gains (or losses) are allocated "above the line." Accounts 105, 411.6, 411.7. This approach reflects a policy that the ratepayers should underwrite the costs of long-range planning but, as a matter of equity, should receive all gains from dispositions of land held for use but never used. *See Accounting Treatment for Land Held for Future Utility Use and for Profits or Losses Realized Through Sales of Those Lands*, 45 F.P.C. 106 (1971).

Another exception pertains to unforeseeable "extraordinary losses on property abandoned or otherwise retired from service," Account 182, *i.e.*, losses (usually exceeding five percent of income) "which could not reasonably have been foreseen and provided for." *Id. See* Gen. Instr. 7. Normally, such losses would be borne by the shareholders in the sense that the normal depreciation chargeable to the ratepayers would not cover the loss as rapidly as the extraordinary loss provisions permit. In the Commission's discretion, however, they can

be shifted to the ratepayers—which is likely to happen unless "the utility is earning a sufficient return and the company has ample time to recover fully the cost of plant through depreciation." SUELFLOW, *supra* at 73. See Account 182, Gen. Instr. 7."[13]

In simplified form, therefore, the accounting treatment which the Uniform System generally accords gains and losses on dispositions of utility property can be depicted as follows:

I. OPERATING UNIT OR SYSTEM	II. NONOPERATING FACILITY	
	A. Depreciable (Plant)	B. Nondepreciable (Land)
[Gains or losses on plant facilities and land allocable to shareholders]	1. Sold upon retirement	2. Sold upon retirement
	[Gains or losses allocable to ratepayers]	[Gains or losses allocable to shareholders]
	2. Transferred to "nonutility" property account; sold thereafter	2. Transferred to "nonutility" property account; sold thereafter
	[Elimination from rate base; gains or losses allocable to shareholders]	[Elimination from rate base; gains or losses allocable to shareholders]
	3. Sold after placement in "held for future use" account	3. Sold after placement in "held for future use" account
	[After elimination from rate base, gains or losses allocable to shareholders] [14]	[After elimination from rate base, gains or losses allocable to ratepayers]

[13] "To be considered as extraordinary under the above guidelines, an item should be more than approximately 5 percent of income, computed before extraordinary items. . . . (See Accounts 434 and 435.)" [Gen. Instr. 7.]

[14] In contrast with land "held for future use," it appears that gains and losses on depreciable utility plant assets carried in that same account are allocable to the shareholders. *See* Accounts 105, 411.6, 411.7, 421.1, 421.2, Plant Instr. 7.E., 10.E.

From this discussion it should be clear that respondents' defense on the basis of adherence to the Uniform System of Accounts may be question-begging, given the considerable room for Commission discretion in characterizing and approving particular accounting entries. For example, the determination as to whether a particular sale involves an "operating" or "retired" facility—which often is far from clear—may determine, as an accounting matter, whether the transaction shall be treated below or above the line.[15] Similarly, the Commission has discretion over inclusion and removal of land, especially retired land, in the "held for future use" account—a critical determination as to allocation of potential gains

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This different treatment of land and plant held in Account 105 appears to be anomalous. *Compare* Account 108, Plant Instr. 10.E., 10.F.

[15] In 1973, the FPC withdrew from further consideration an earlier proposal to modify Plant Inst. 5.E. to provide "above the line" treatment of gains and losses on the sale of operating units or systems. Chairman Nassikas dissented, citing his belief that there commonly was abuse of discretion in characterizing facilities either as "operating" or "retired," in order to benefit investors over consumers. *Accounting Treatment to Account for Gains and Losses on the Disposition of Utility Property That Had Been Classified in Utility Service and Consolidation of Certain Depreciation Accounts*, 49 F.P.C. 390, 404 (1973) (Nassikas, Ch., dissenting.)

> Our experience reveals that when losses occur ordinary retirement accounting is more likely to be followed, but when a gain is indicated the specialized accounting for sales of plant is elected. [*Id.* at 405.]

The Chairman illustrated his point:

> The term "operating unit or system" has never been specifically defined by the Commission. A 10.14 mile section of pipeline (7 FPC 279) and a 7.586 mile section of a transmission line (32 FPC 1263) have been held to be operating units or systems. [*Id.* at 404 n.2.]

and losses to ratepayers or shareholders. The Commission, moreover, has discretion to determine whether retired property should—or should not—be transferred to a nonutility property account, with the consequent impact on rate base and eventual allocation of the proceeds upon sale. Finally, the allocation of an "extraordinary loss" to ratepayers or shareholders is discretionary.

This is not to say that reliance on the Uniform System as a basis for ratemaking is unjustified in the present case. Obviously, the System, which is designed to assist in ratemaking, reflects years of fine tuning premised on expert views about balancing investor and consumer interests. Moreover, many of the prescribed accounting treatments discussed above, subject to the Commission's discretionary gloss, are not relevant to this case. Despite these considerations, however, we must conclude that because of the substantial discretion of the Commission under the System, a defense of particular ratemaking based on per se application of that System says little more than "ratemaking based on expert Commission discretion." Thus, before we can draw a conclusion as to whether reliance on the Uniform System in this case provides a rational connection between the companies' land transactions and the Commission's decision to place them for ratemaking purposes "below the line," we have to examine the System very carefully as applied here.

C. *The Uniform System of Accounts as Applied*

The precise question is this: have petitioners made a "convincing showing" that the Commission's rate determinations are unreasonable, unjust, or discriminatory, D.C. Code 1973, § 43-301, because the decision in each case to allocate gains on particular dispositions of retired land exclusively to the investors is not rationally con-

nected by "reliable, probative, and substantial evidence," D.C. Code 1977 Supp., § 1-1509(e), to the rate of return selected? Thus, we are asked to relate gains on *particular* land transactions to the Commission's determination of an overall *rate* of return—a complex inquiry.[16]

We must focus, of course, as much on the consumer interest as on the investor interest. According to the concurring Justices in *Natural Gas Pipeline*:

> The consumer interest cannot be disregarded in determining what is a "just and reasonable" rate. Conceivably, a return to the company of

[16] If the gains on the land are deemed relevant to the ratemaking process, they would comprise one factor—a "land transactions" component of a utility company's overall gain-loss situation—to be evaluated by the Commission as a long-run issue of ratemaking policy for the company. Thus if, for the sake of argument, the Commission were to conclude that gains on land should be credited to the ratepayers, this does not necessarily mean that all the gains at issue here should be credited, dollar for dollar, to the customers' rate *payments*; nor does the conclusion suggest how land sales in the test year or earlier should be used to help forecast company revenues, as part of the rate-of-return calculation. The Commission, therefore, would have to deal with the following questions, among others: (1) To what extent, if at all, should the ratepayers' failure to challenge and appeal allocation of these gains prior to the test year foreclose their receiving credit for the gains now, as an offset to scheduled rate payments? (2) To what extent do gains on land sales during the test year provide an appropriate—or distorted—basis for projecting gains into the future, as part of the company's projected revenues? Conceivably, after dealing with these and other questions, the Commission could conclude that the ratepayers are entitled to less credit than claimed for past transactions, and/or that calculation of the rate of return for the future should not reflect use of test-year figures alone for gains realized on land.

> the cost of the service might not be "just and reasonable" to the public. [*Federal Power Comm'n v. Natural Gas Pipeline Co.*, *supra* at 607 (Black, Douglas, and Murphy, JJ., concurring).]

With equal force, the United States Court of Appeals for the District of Columbia Circuit has stressed that "the end of public utility regulation has been recognized to be protection of consumers from exorbitant rates." *Washington Gas Light Co. v. Baker*, *supra* at 119, 188 F.2d at 15 (footnote omitted). We therefore must examine how the Commission has accommodated consumer, as well as investor, interests in (1) selecting and (2) applying its ratemaking criteria. *See* Part II.A., *supra*.

1. The Commission announced generalized criteria for the WGL and Pepco rate determinations. As to WGL, the Commission recognized an "earnings slump" in recent years. Accordingly, the Commission saw a need for the company to have "an opportunity to regain a level of earnings needed to attract capital and to protect its financial integrity." (PSC Final Opinion and Order No. 5833, October 29, 1976, at 1-2.) The Commission tied the customers' interest to WGL's financial health in two ways:

> [1] Since customers pay all the Company's capital costs, they gain by keeping those costs within prudent bounds. [2] Even more importantly, consumers have an overriding interest in continued service which rivals their interest in low rates. By aiding the Company to maintain financial stability, the Commission helps to insure high quality gas service. [*Id.* at 2.]

As to Pepco, the Commission noted that the company had "turned the economic corner" since prior proceedings.

PSC Proposed Opinion and Order No. 5831, October 20, 1976, at 3. Thus, the Commission approached its decision

> without the anxiety inherent in an attempt to rescue a floundering if not drowning utility, admittedly unable to save itself, but rather with the objective of affording Pepco an opportunity to achieve an appropriate degree of financial stability and to earn a just and reasonable rate of return, while at the same time assuring that the retail electric customers of Pepco in the District of Columbia will pay rates no higher than necessary to afford Pepco that opportunity. [*Id.* at 3-4.]

These criteria, while not overly precise, reflect the factors specifically approved by the Supreme Court. *See Permian Basin Area Rate Cases*, *supra* at 791-92 (quoted at note 4, *supra*). Moreover, the very contrast between the respective overall analysis of WGL and Pepco reflects an intention to balance investor and consumer interests very carefully in each company's situation. Finally, none of the parties has challenged the criteria, as articulated. We hold, therefore, that these criteria are acceptable.

2. We turn, therefore, to the question whether the particular elements of the rate orders satisfy the criteria selected.

The Commission has concluded, with respect to both companies, that the proper balancing of consumer and investor interests requires all gains (and losses) on ordinary transactions in land retired from service to be allocated to the investors. This decision is based on a conscious application of the Uniform System of Ac-

counts to the ratemaking process, coupled with a specific conclusion that a contrary allocation policy would be ill advised because consumers, as a result, would be exposed to routine losses.

> If the Commission passes those gains to consumers, then it can no longer protect consumers from being charged with losses on land transactions which are routine. Once People's Counsel's proposal is adopted, as its witness acknowledged (Tr. 1080), the Commission should follow a rule compelling customers to underwrite the Company's property losses in ordinary circumstances. The Commission is not inclined to follow that path. [PSC Final Opinion and Order No. 5833, Oct. 29, 1976, at 58 (WGL).]

See PSC Proposed Opinion and Order No. 5831, Oct. 20, 1976, at 34-36 (Pepco); PSC Opinion and Order No. 5849, Dec. 16, 1976, at 9-10 (Pepco).

Petitioners counter with one principal argument: because the ratepayers have borne the "burdens" (*i.e.*, taxes and other carrying charges) of providing a "return" on the land while in the rate base, they are entitled to the "benefits" received upon sale, in accordance with principles announced by the United States Court of Appeals for the District of Columbia Circuit in similar litigation directed at the Washington Metropolitan Area Transit Commission ("WMATC").[17] *Democratic Central Com-*

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[17] In the WGL case, petitioners also argue that allocation of the contested gains to the shareholders is unreasonable and unjust because such treatment is inconsistent with the Commission's imposition of "extraordinary" losses on the ratepayers from the "Brandywine" property. Petitioners, however, do not challenge the Brandywine result itself—either the

mittee I, supra; Bebchick v. Washington Metropolitan Area Transit Comm'n, 158 U.S.App.D.C. 79, 485 F.2d 858 (1973); *Democratic Central Committee v. Washington Metropolitan Area Transit Comm'n*, 158 U.S.App. D.C. 107, 485 F.2d 886 (1973) *cert. denied*, 415 U.S. 935 (1974) (*"Democratic Central Committee II"*).[18]

In the *Democratic Central Committee* litigation, the circuit court overturned decisions by WMATC to credit the shareholders of D.C. Transit System, Inc. (Transit) with the capital gains accruing to Transit on its disposition of depreciable and non-depreciable properties acquired at a total price considerably below book value from Capital Transit Company (Capital) in 1959. Transit had acquired Capital's streetcar-bus system subject to a condition imposed by Congress, as part of the franchise award, that Transit convert the enterprise to an all-bus system throughout the metropolitan area. *Democratic Central Committee I, supra* at 33, 485 F.2d at 812. This was to involve "removal of abandoned streetcar tracks

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characterization of the losses as "extraordinary" (*see* Gen. Instr. 7) or the appropriateness of their allocation to the ratepayers. Nor do petitioners specifically advance a rate-making principle that extraordinary losses and gains generally should be allocated to the same group, ratepayers or shareholders. We therefore hold that the Commission's Brandywine decision is irrelevant to this proceeding; it does not in itself imply a particular result here. Petitioners are free, however, on remand to advance the Brandywine decision as evidence, to the extent it has probative value, on the broader question whether, under all the circumstances, allocation of the gains on land transactions to the shareholders is unreasonable and unjust.

[18] These decisions are not binding on our court. *See M.A.P. v. Ryan*, D.C.App., 285 A.2d 310 (1971).

and regrading and repaving of the abandoned track areas, at an estimated cost of $10,441,958 [footnotes omitted]." *Id.* The Commission authorized Transit to charge this cost of track removal, regrading, and repaving to its customers through adjustments in the rate structure while awarding all gains on disposition of nonoperating trolley facilities to Transit's shareholders—arguably amounting to an investor windfall in view of the acquisition price at considerably below book value.

Simply put, the circuit court concluded that the net result of these transactions, as approved by WMATC, was unfair to the ratepayers. In taking this position, the court stressed the windfall aspect.

> What the investors bought was an ongoing mass-transportation system with physical components, including the lands in question, long since dedicated to public service. We do not mean to imply that had that not been the case, value-appreciations would necessarily have been immune to claims of farepayers. We do say that since that was the case, it makes those appreciations more susceptible to those claims. [*Democratic Central Committee II, supra* at 120, 485 F.2d at 899.]

The court thereupon distinguished the Transit situation from one in which "the properties [had] been originally purchased outright by Transit's investors with a view to deployment as they pleased." *Id.*

The windfall aspect—the peculiar equity—of the D.C. Transit situation is not apparent in the case before us; the *Democratic Central Committee* litigation is distinguishable as more egregious on the facts. Nor do other cases lend automatic support to petitioners' position. Litigation over allocation of gains on nondepreciable assets

has been infrequent, although courts outside the District of Columbia generally have followed a "gain follows the risk of . . . loss" principle. *Democratic Central Committee I*, *supra* at 19, 55-56, 485 F.2d at 798, 834-35. This has resulted, as the case may be, in allocation to the customers, *see, e.g., New York Water Service Corp. v. Public Service Comm'n*, 12 A.D.2d 122, 208 N.Y.S.2d 857 (1960), or to the shareholders, *see, e.g., City of Lexington v. Lexington Water Co.*, 458 S.W.2d 778 (Ky. 1970). In the District of Columbia, there is no judicial precedent aside from the *Democratic Central Committee* litigation. (Prior to these circuit court decisions, administrative rulings by WMATC and the PUC had routinely allocated gains on nondepreciable assest to the investors. *See Democratic Central Committee I*, *supra* at 19-20, 55-56, 485 F.2d at 798-99, 834-35.)

It may be true, as petitioners argue—and as the circuit court indicated in *Democratic Central Committee I*, *supra* at 32, 485 F.2d at 811—that in an environment of steadily climbing land values, application of the "gain follows risk of loss" principle is not a meaningful test. But even so, petitioners, in relying on the supposed conclusiveness of the circuit court cases, have not carefully developed their own fundamental argument that the ratepayers, in bearing the "burdens" of taxes and other carrying charges on the land while in the rate base, have the superior claim to the "benefits" here. For example, they have not analyzed the relevance, if any, of the source of the capital for the land—investors or ratepayers.[19] More

[19] The facts showing who contributed the capital for acquiring the land have not been developed in the record, but a number of published decisions indicate that we cannot automatically assume the investors did so alone. The answer may

be very complicated and thus difficult to find because of the following ratemaking history.

The Commission's predecessor, the Public Utility Commission (PUC) of the District of Columbia, allowed the burden of the writedowns occasioned by plant reclassifications during the nineteen-thirties and -forties (*see* Part III.A., *supra*) to be shifted substantially to the ratepayers, notwithstanding the PUC's adoption of the Uniform System of Accounts. In prescribing the Uniform System for Pepco and WGL, *see* Order No. 1559, PUC No. 3182, Dec. 31, 1936 (Pepco) and Order No. 1846, PUC No. 3197/1, Jan. 11, 1940 (WGL), the PUC did not order an abrupt transition; it required the System to be phased in over a long period of time. More particularly, the PUC conditioned application of the System on the continued use by Pepco and WGL of the "sliding scale" rate formula (sometimes referred to as the "Boston Sliding Scale"), which the PUC had promulgated earlier for these companies, *see* Order No. 1476, Feb. 5, 1936 (Pepco) and Order No. 1458, Dec. 13, 1935 (WGL), pursuant to a consent decree entered by the federal district court in 1924. *See Potomac Electric Power Co. v. Public Utilities Comm'n.*, 81 U.S.App.D.C. 225, 226-28, 158 F.2d 521, 522-24 (1946), *cert. denied*, 331 U.S. 816 (1947). In accordance with this formula, all newly acquired assets were to be valued at their original cost, but the assets held as of 1935—the year of a PUC property valuation—were to continue in the rate base at their reproduction cost (on which the 1935 valuation had been based). As a result, these reproduction cost elements were not to disappear from the rate base until the related assets themselves were retired from service. *See Washington Gas Light Co. v. Byrnes*, 78 U.S.App.D.C. 107, 108-09, 137 F.2d 547, 548-49 (1943), *aff'd*, 321 U.S. 489 (1944).

Accordingly, petitioners here may have a demonstrable basis for the following argument: by continuing to pay on an inflated (though declining) rate base over a period of years, the ratepayers have provided rates of return consistently higher than those which the Commission had found to be just and reasonable. *Potomac Electric Power Co. v. Public Utilities Comm'n.*, *supra* at 227, 158 F.2d at 523. Thus, the ratepayers, in effect, have paid the company for the appreciation of rate-base assets and/or acquisition of other property to be added

important, they have not analyzed the likely impact of their proposed allocation on the financial strength of the company, including the market price of its stock.

Instead, petitioners argue a generality.

> [I]t is logically inconsistent to deny the shareholders the benefit of a market value rate base (by use of original cost as a rate base) and simultaneously to grant them the in-service appreciation of the rate base to market value. . . . If the shareholders in an original cost jurisdiction like the District of Columbia are not entitled to a *return* on the appreciation in value, then it is inconsistent to allow them to retain the *capitalized value* of this return (*i.e.*, the appreciation in value). [Petitioner WPIO's brief at 6; emphasis in original.]

This contention misses the mark. The Commission's ratemaking authority is not limited to wooden, symmetrical

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to the rate base (through capitalization of excess earnings). It would follow that the ratepayers should benefit from the gains on sale of property in which they, in this manner, invested; the company should not be paid twice.

This argument, however, is far from conclusive. It has not been developed in the record, including evidence as to how the 1935 cost data is traceable, if at all, to the values of the properties involved in the land transactions here. Yet, on the basis of published PUC orders, there is some evidence that Pepco's and WGL's ratepayers may have an equitable claim (based on *de facto* capital contributions) to a portion of the land values at issue. Obviously, the claim is more elusive, less dramatic, and spread back further over time than the ratepayers' equitable assertions in the *Democratic Central Committee* cases, but the claim, nevertheless, appears theoretically available—unless overshadowed, on the ground of staleness, by more recent, valid investor expectation.

applications of standard criteria. Just as the gains on land outside the rate base are not inexorably awardable to the shareholders, they also are not inexorably assignable to the ratepayers simply because the land was once a part of the rate base.[20] The Commission, rightly or wrongly, has ordained the shareholders to be the more appropriate beneficiaries of the gains. Given the presumptive validity of the Commission's expert judgment in balancing investor and consumer interests, taken against petitioners' own incomplete analysis, we must conclude that petitioners have not made the "convincing showing" required to overturn a rate order. They cannot prevail at this time.

3. It does not follow, however, that the rate orders are valid. Petitioners' argument is not frivolous; it is a plausible thesis, as the *Democratic Central Committee* litigation attests. Petitioners' failure to come to grips with the issue may be due to the ultimate invalidity of their position; but it may be due, instead, to the utility companies' failure to develop the administrative record sufficiently to support the Commission's order with respect to the land gains issue, or to the Commission's failure to draw upon the record in a way that sufficiently supports its land gains conclusion. Thus, as indicated in Part II, *supra*, we have a responsibility to hold the Commission accountable for explaining its actions fully and clearly, based on substantial evidence of record. Accordingly, respondents are obligated to come forward with evidence confirming that the Commission's decision to allocate all gains to the shareholders on the particular dispositions

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[20] If the Commission were to prevail, petitioners presumably would oppose the logic of increasing the rate base to reflect the current value of nondepreciable assets used in service to the public.

of retired land at issue are rationally connected by "reliable, probative, and substantial evidence" to the rates of return selected. It is therefore important, finally, to consider whether the Commission has done a complete enough job.

The Commission has arrived at 9.25% and 9.06% overall rates of return for WGL and Pepco, respectively. The methodology is said to be a discounted cash flow (DCF) analysis based on a comparison of WGL and Pepco securities, respectively, with those of other utility companies in the same categories of risk. More particularly, the Commission evaluated, with the help of such comparison, what current dividend yield per share, coupled with an expected growth in dividend, would be required to maintain each company's common stock price at or slightly above book value. (According to the Commission, this is the yield, including growth, minimally required to assure the company's financial integrity while keeping faith with the consumers' right to "no higher" than a just and reasonable rate of return.) The Commission then combined this figure with weighted averaging of essential rates of return on preferred stock, long-term debt, and (for WGL) customer deposits to determine each company's overall rate of return.[21] Once this

[21] The result for WGL was a projected 13.4% return on common equity, a figure which took into account that "the company's price per share has fallen below book value." When this 13.4% return was combined through weighted averaging with essential rates of return on preferred stock (6.5%), long term debt (7.1%), and customer deposits (6.0%), the overall rate level became 9.25%.

Similarly, the Pepco overall rate-of-return level became 9.06% based on weighted averaging of projected returns from equity (13.00%), preferred stock (7.87%), and debt (6.92%). Apparently, all parties to the Commission proceeding agreed that the "market price should exceed book"

overall rate was calculated, the Commission applied it to each company's rate base in the test year to determine overall utility revenues. Finally, since the existing customer rate schedule would not yield these essential revenues, the Commission approved a rate increase to the level required for each company to achieve the established overall rate of return (on the rate-base assets). It is necessary to analyze, therefore, how the capital gains on land are reflected—if at all—in this process.

We begin by noting that the price of a utility company's common stock reflects the financial return on both utility and nonutility operations (if any); thus, the Commission's DCF methodology presupposes that WGL's or Pepco's nonutility transactions will bring, on the average, virtually the same rate of return as the utility side of the business. Otherwise, depending on their magnitude, the company's nonutility transactions are likely to affect the dividend yield per common share (and thus the stock price), up or down, compared to the yield (and price) premised on the Commission-approved rate of return. For example, one result of different rates of return on a company's utility and nonutility operations might be that nonutility revenues, when coupled with earnings derived from the approved utility rate of return, would produce a higher total return to investors from all the company's operations than the Commission had deemed necessary to maintain the price of common stock at the appropriate level. Alternatively, of course, nonutility transactions might be a drag on the company, causing a lower overall rate of return than the Com-

value; the "companies selected as comparable to Pepco have experienced a substantially lower return on equity than that recommended by Pepco witnesses, but have nevertheless achieved a market to book rate of approximately 1.3."

mission had thought essential to sustain investor interest. We therefore have to consider what bearing, if any, a company's nonutility transactions have on ratemaking—especially transactions involving nonutility property, such as the lands at issue here, that were formerly part of the rate base.

The Federal Power Commission has taken the position that ratepayers have no right to revenues derived from nonutility operations. *Re Duke Power Co.*, 97 P.U.R.3d 396 (1972) (disallowed discovery into transactions of a utility company's land and lumber company subsidiary). Even if true, however, that principle does not reach a fundamental question in the present case: to what extent do earnings from nonutility transactions affect the stock price? Without an answer to that question, a regulatory commission will not have enough data to determine how much revenue should be generated from the utility side of the business to cover its share of maintaining the common stock.

More particularly, apropos of *Duke Power*, if the company had a booming nonutility operation, such as a lumber company, in contrast with a struggling utility division, a regulatory commisison might be acting capriciously if it permitted utility revenues to remain so low that the nonutility side—the investors—were substantially subsidizing the utility customers, especially when the customers had contributed nothing to the nonutility assets. That would raise a fundamental question about the Commission's reaching beyond its jurisdiction over utility operations. On the other hand, let us assume a transfer of property out of the rate base to the nonutility side, resulting (after eventual sale) in substantial capital gains to the company based on appreciation while in the rate base—as in the present case. Assume, further,

that these gains alone are responsible for a higher market price of the stock than the price deemed essential by the Commission (based on comparisons with other utility stocks) to attract investors and thus maintain the company's financial integrity. Arguably, then, the customers could have an equitable claim to those gains, depending on factors such as contributions to taxes, carrying charges, and capital for the land. Another relevant factor might be risk of loss while the land was in the rate base, perhaps discounted by how real—or unreal—that risk was when compared with the prospect for gain.[22] Given such equitable considerations, therefore, the fact that the Commission had permitted the company to transfer the land to a nonutility account before sale would not be determinative of the Commission's jurisdiction to consider the gains on that land for ratemaking purposes.[23]

There is no indication in the record that the Commission, in determining the essential rates of return for WGL and Pepco, actually considered the impact of land transactions on the price of either company's common stock. We therefore confront an unanswered question:

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[22] "It would be little more than an exercise in abstract logic to invoke the principle of gain-follows-loss where the financial risk is wholly illusory." *Democratic Central Committee I*, *supra* at 32, 485 F.2d at 811.

[23] In this connection, assume that the lands were still in the rate base at the time of sale as part of an ordinary retirement of a nonoperating facility. Under the Uniform System of Accounts, the gains would be allocable to the shareholders, just as they are after the property has been transferred to a nonutility account. *See* Part III.B., *supra*. According to our analysis in the text above, however, the allocation of such gains must be legally justified on an ad hoc basis (as an explicit part of the DCF analysis or other methodology) not merely by reference to the uniform accounting system.

was the Commission's allocation of the gains to the shareholders related to its announced criteria stressing protection of the companies' financial integrity; or, instead, was it attributable to a normative judgment that the shareholders alone, as owners, have a "right" to the gains?

It may be, apropos of the first alternative, that the Commission, in rethinking the rate structure with reference to company land transactions, would conclude that investors over the years have expected—and should continue to expect—that ordinary gains on land retired from service will inure to their benefit, and that these expectations have been reflected in the price of stock, with a consequent impact on the companies' ability to attract capital. If this is the case—*i.e.*, if the appreciation accruing on nondepreciable property in the utility's rate base has been fully capitalized into the stock price—then the Commission may conclude that these gains already have inured to the benefit of ratepayers in the sense that the stock price, and thus the company's earnings (including customer payments), are at the lowest justifiable level. On the other hand, in facing the question squarely, the Commission may conclude that investors have not had—or in the future should not have—reason to anticipate that they will receive all gains which accrue on nondepreciable property during the period while in the rate base. In that case, the stock price would not reflect allocation of the gains on land to the investors, and the Commission would be faced with essentially an equitable question: whether there exists a justification for the investors to receive the benefit of capital appreciation of rate-base assets, in excess of the return necessary to assure the company's financial integrity, without giving any corresponding benefit to the ratepayers.

We are not willing to speculate on what the Commission's position may be on these questions, absent evidence in the record that they have been explicitly and substantially addressed. However, two implications of such an inquiry by the Commission should be stressed to guide future consideration. First, equitable principles commonly used in utility-rate cases, such as "benefits follow burdens" or "gain follows risk of loss," would be irrelevant if the Commission's DCF analysis were to show that the minimum essential price of common stock presupposes an allocation of all capital gains on land to the shareholders. That is to say, if the Commission were to conclude that allocation of the gains on the land to the ratepayers, rather than the shareholders, would cause a drop in stock price below the minimum level required to attract investors, then such allocation to the ratepayers would be meaningless, for there would have to be an offsetting increase in the rate of return to maintain the stock price. Second, if the Commission's DCF analysis were to show, to the contrary, that allocation of the gains to the shareholders would boost the stock price above the required minimum, or that allocation of the gains to either group, shareholders or ratepayers, could not be shown to affect the stock price, up or down, then the Commission would have to deal more directly with all the equitable factors under the controlling mandate of *Natural Gas Pipeline*, *supra*, and *Hope Natural Gas*, *supra*, namely that the company's "financial integrity" is all the Commission is obliged to guarantee the investors. Whether the Commission is permitted to guarantee the investors more, given the statutory standard requiring just and reasonable rates, is a question that is not now before us.

In summary, the Commission has not yet explained its financial analysis connecting the disputed land transactions to its rate orders. The Commission has merely

quoted from a 1975 rate determination where, in response to WPIO's raising the same issue, the Commission did no more than distinguish the *Democratic Central Committee* cases on their facts and issue the following conclusional—but not at all conclusive—statement:

> Treatment in accordance with the company's handling of this matter is in accordance with the FPC Uniform System of Accounts which this Commission has adopted, thereby establishing its policy on this issue. An ex post facto change in this policy would be inappropriate. [*Re Potomac Electric Power Co.*, 11 P.U.R.4th 215, 237 (PSC D.C. 1975).]

See PSC Proposed Opinion and Order No. 5831, Oct. 20, 1976, at 34-36. The Commission in the present cases, therefore, has not advanced affirmative, particularized reasons justifying its treatment of the capital gains on land. Unless and until the Commission does so, reflecting attention to the consumer as well as investor interest, we cannot say that the Pepco and WGL rates at issue here have been established on the basis of "reliable, probative, and substantial evidence." D.C. Code 1978 Supp., § 1-1509(e)

Accordingly, we hold that when a regulatory commission calculates and approves an overall rate of return (and consequent rate schedule) for utility operations, based on comparative stock prices, it must factor into its determination an analysis of the impact of nonutility transactions on the price of the company's stock, including specific findings and conclusions as to whether—and why—the investors, the ratepayers, or both, have a claim to nonutility revenues, especially those derived from former utility property (such as the land at issue here) which appreciated while in the rate case. Mere reference

to the Uniform System of Accounts begs the question; it will not suffice.

IV. *Conclusion*

In *S.E.C. v. Chenery Corp.*, 318 U.S. 80 (1943), the Supreme Court articulated our central point as follows:

> The Commission's action cannot be upheld merely because findings might have been made and considerations disclosed which would justify its order as an appropriate safeguard for the interests protected by the Act. . . . For the courts cannot exercise their duty of review unless they are advised of the considerations underlying the action under review. . . . [T]he orderly functioning of the process of review requires that the grounds upon which the administrative agency acted be clearly disclosed and adequately sustained. [*Id.* at 94.]

We therefore remand the proceedings for clarification, pursuant to our authority under D.C. Code 1973, § 43-705.[24]

We direct the Commission to issue supplementary findings and conclusions, consistent with this opinion, supporting the present or revised rate orders. The Commission may, in its discretion, rely on the present record or re-

[24] The court "may require and direct the Commission to receive additional evidence upon any subject related to the issues on said appeal concerning which evidence was improperly excluded in the hearing before the Commission or upon which the record may contain no substantial evidence." D.C. Code 1973, § 43-705. Implicitly, under § 43-705 the court, prior to concluding its hearing of the appeal, also may require clarification of the Commission's findings and conclusions short of reopening the record for additional evidence.

open the record for receipt of supplementary evidence and supporting papers by all parties. The Commission, in any event, shall give all parties an opportunity to comment on its proposed findings, conclusions, and orders before the Commission deems them final for our further review. The Commission's findings, conclusions, and orders shall be filed with this court, accompanied by supporting decisions or memoranda and the records of the proceedings on remand. Within 30 days of that filing with the court, the petitioners and intervenors shall file their responses, after which this court will either set the matter for hearing or proceed directly to make its decision.

On one point we hope to be especially clear. By holding that the Commission's orders are not supported by substantial evidence, we are not suggesting that petitioners are—or are not—likely to prevail. We merely are holding that petitioners have presented a challenge that requires a satisfactory answer, and that to date the Commission, in failing to respond with particularity, has not sufficiently connected its decisions on the allocations of gains on land to its determinations of particular rates of return.

Our position is better expressed in the following words of Judge Prettyman:

> This court, in the present case, has not reversed the conclusions of the Commission, except in the procedural sense necessary to a remand. It has remanded the case for clarification where clarity is not present, and for completion where incompleteness now exists. When the findings and conclusions are complete and clear, the court will then, if appropriate proceedings are brought, consider whether the ultimate rulings of the Commission are within the premissible bounds of

> its power. [*Mississippi River Fuel Corp. v. Federal Power Comm'n*, 82 U.S.App.D.C. 208, 227, 163 F.2d 433, 452 (1947).]

Remanded for further proceedings.

NEBEKER, *Associate Judge*: It has been and remains my intention to dissent from the majority's disposition of this case, principally because of my conviction that the majority sorely misconceives our proper review role in cases of this nature.

The question of the scope of our review is among the issues which now are pending before the court en banc in *Potomac Electric Power Co. v. Public Service Commission*, No. 10490. It is my belief that we should not dispose of this case until the en banc case has been resolved. The majority, nonetheless, has elected to publish its opinion before the preparation of my dissent. It does so under Part VIII, Paragraph G, of our new Internal Operating Procedures (from the adoption of which I dissented).

I shall write and release my dissent in this case as soon as feasible after the court's resolution of the en banc proceeding in No. 10490.

APPENDIX E

DISTRICT OF COLUMBIA
COURT OF APPEALS

No. 11780

November 2, 1978

WASHINGTON PUBLIC INTEREST ORGANIZATION, *et al.*,
Petitioners,

v.

PUBLIC SERVICE COMMISSION OF THE DISTRICT OF COLUMBIA,
Respondent,

WASHINGTON GAS LIGHT COMPANY,
Intervenor.

No. 11786

PEOPLE'S COUNSEL,
Petitioner,

v.

PUBLIC SERVICE COMMISSION OF THE DISTRICT OF COLUMBIA,
Respondent,

WASHINGTON GAS LIGHT COMPANY,
Intervenor.

No. 12017

WASHINGTON PUBLIC INTEREST ORGANIZATION, *et al.*,
Petitioners,

v.

PUBLIC SERVICE COMMISSION OF THE DISTRICT OF COLUMBIA,
Respondent,

POTOMAC ELECTRIC POWER COMPANY
Intervenor.

Order

The court presently has pending petitions for rehearing *en banc* filed by intervenors. It is

ORDERED, *sua sponte*, counsel for respondent shall file a legal memorandum on or before November 20, 1978 regarding the point made in the last full paragraph, page 1, and the last two paragraphs of Section IIA, pages 4 and 5 of the petition filed by Potomac Electric Power Company, addressing itself particularly to the continued validity of *Board of Public Utility Comm'ers* v. *New York Telephone Company*, 271 U.S. 23 (1926).

BY THE COURT:

/s/ THEODORE R. NEWMAN, JR.
Chief Judge

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APPENDIX F

DISTRICT OF COLUMBIA
COURT OF APPEALS

No. 11780

May 3, 1979

WASHINGTON PUBLIC INTEREST ORGANIZATION, *et al.*,
Petitioners,

v.

PUBLIC SERVICE COMMISSION OF THE DISTRICT OF COLUMBIA,
Respondent,

WASHINGTON GAS LIGHT COMPANY,
Intervenor.

No. 11786

PEOPLE'S COUNSEL,
Petitioner,

v.

PUBLIC SERVICE COMMISSION OF THE DISTRICT OF COLUMBIA,
Respondent,

WASHINGTON GAS LIGHT COMPANY,
Intervenor.

No. 12017

WASHINGTON PUBLIC INTEREST ORGANIZATION, *et al.*,
Petitioners,

v.

PUBLIC SERVICE COMMISSION OF THE DISTRICT OF COLUMBIA,
Respondent,

POTOMAC ELECTRIC POWER COMPANY
Intervenor.

BEFORE: *Newman, Chief Judge; Kelly, Kern, Gallagher, *Nebeker, Yeagley, Harris,Mack, and *Ferren, *Associate Judges.*

Order

On consideration of the petitions for rehearing and for rehearing en banc, and it appearing that a majority of this Court has voted to deny, it is

ORDERED for the merits division that the petition for rehearing is denied; and it is

FURTHER ORDERED that the en banc petitions are denied.

PER CURIAM

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* Denotes merits divison.

Associate Judges Nebeker and Harris vote to grant the petition for rehearing en banc; and Judge Nebeker will include in his dissent to the panel decision his reasons for voting to grant rehearing en banc. The dissenting opinion is expected to be issued pursuant to the reservation expressed at the time of publication of the majority decision.

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APPENDIX G

DISTRICT OF COLUMBIA COURT OF APPEALS

No. 11780

WASHINGTON PUBLIC INTEREST ORGANIZATION, ET AL.,
PETITIONERS,

v.

PUBLIC SERVICE COMMISSION OF THE
DISTRICT OF COLUMBIA, RESPONDENT,

WASHINGTON GAS LIGHT COMPANY, INTERVENOR.

No. 11786

PEOPLE'S COUNSEL, PETITIONER,

v.

PUBLIC SERVICE COMMISSION OF THE
DISTRICT OF COLUMBIA, RESPONDENT,

WASHINGTON GAS LIGHT COMPANY, INTERVENOR.

No. 12017

WASHINGTON PUBLIC INTEREST ORGANIZATION, ET AL.,
PETITIONERS,

v.

PUBLIC SERVICE COMMISSION OF THE
DISTRICT OF COLUMBIA, RESPONDENT,

POTOMAC ELECTRIC POWER COMPANY, INTERVENOR.

393 A.2d 71 (1978)

[1782]

Separate Dissenting Statement by NEBEKER, *Associate Judge.*

Filed July 17, 1979

In my statement filed on September 12, 1978, *see Washington Public Interest Organization v. Public Service Commission*, D.C.App., 393 A.2d 71, 94 (1978), I reserved the right to dissent until after the opinion in *Potomac Electric Power v. Public Service Commission*, D.C.App., —— A.2d —— (No. 10490, decided May 14, 1979) (en banc), was filed. I did so because of inconsistencies I perceived between the drafts of the majority in this case and the en banc case. While I joined in Judge Harris' dissent in the en banc case, it seemed clear to me that my colleagues in this case were not coordinating their position with their votes in the en banc case. They thus were taking contrary views, a circumstance which I was not earlier free to express without divulging the yet to be published outcome and rationale in the en banc case. My request of my colleagues to delay issuance of the majority opinion in this case was not honored.

I. Scope of Review—Inconsistency in the Majority and En Banc Opinions

The scope of review concepts applied in the majority opinion in this case sharply contrast with the scope of review expressed and applied in *Potomac Electric Power Co. v. Public Service Commission, supra.* The two opinions conflict expressly and implicitly on (1) the authority defining our scope of review, (2) the "burden" on the agency to explain the rationale for its conclusions and (3) the "burden" on this court to address issues not raised, briefed or mentioned by the parties at either the

administrative or the appellate level. Although the majority has gone to a great length to establish this as a landmark case regarding our scope of review in rate matters, the en banc decision casts considerable doubt on the viability of certain of the majority opinion's fundamental premises. In fact, the en banc case does not cite the majority opinion in addressing the topic of scope of review.[1]

The majority and en banc opinions differ in explaining the authority defining our scope of review. Both agree that our scope is governed by D.C. Code 1973, § 43-706.[2] From this common ground, however, the opinions evolve in different directions. The en banc decision defines our scope of review more narrowly than the majority decision does. The en banc opinion states that a different scope of review applies for rate proceedings than for other types of administrative cases. Further, it states that "[o]ur review of a utility commission order is the narrowest judicial review in the field of administrative law." Slip op. at 7. In conjunction with this view, the en banc opinion conspicuously (and correctly) omits any citation to the scope of review provisions of the District of Columbia Administrative Procedure Act (D.C.A.P.A.),

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[1] The sole reference in the en banc case to the majority opinion in this case is at slip op. 12 n.5.

[2] D.C. Code 1973, § 43-706 provides:

> In the determination of any appeal from an order or decision of the Commission the review by the court shall be limited to questions of law, including constitutional questions; and the findings of fact by the Commission shall be conclusive unless it shall appear that such findings of the Commission are unreasonable, arbitrary or capricious.

D.C. Code 1973, § 1-1501 *et seq.*[3] By contrast, the majority opinion sets forth a much broader scope of review. To the majority, there is no distinction between our scope of review of utility rate orders and our scope of review of

[3] The en banc court's determination, that the D.C.A.P.A. provisions on scope of review are inapplicable to utility rate order reviews, is supported by the provisions defining the scope of the D.C.A.P.A. Section 1-1510 states:

> The review of all administrative orders and decisions by the court shall be limited to such issues of law or fact as are subject to review on appeal under *applicable statutory law, other than this chapter. In all other cases* the review by the court . . . shall be in accordance with [, *inter alia,*] D.C. Code 1978 Supp., §§ 1-1510(1) to -1510 (3). [Emphasis added.]

Title 43 of the D.C. Code, and in particular D.C. Code 1973, § 43-706 (quoted above), prescribes our scope of review of utility rate orders. Title 43, therefore, is the "applicable statutory law" referred to in § 1-1510. As utility rate proceedings on appeal fall within the ambit of the first quoted sentence of § 1-1510, the second sentence is inapplicable because, by its terms, it covers only cases not governed by the first sentence. The implicit decision by the en banc court, that the scope of review provisions of the D.C.A.P.A. are inapplicable to utility rate cases, is consistent with the § 1-1510 provisions which define the scope of the section's subsections.

The en banc court's determination is also consistent with *Chesapeake & Potomac Telephone Co. v. P.S.C.*, D.C.App., 339 A.2d 710, 712-14 (1975). The court there stated that "*except in the area of* appellate procedure and *scope of review*, the drafters of the APA intended the [APA] to apply to the [Public Service] Commission." *Id.* at 712-13 (emphasis added). The District of Columbia Administrative Practice manual, prepared by the drafters of the D.C.A.P.A., did not intend the D.C.A.P.A. to prescribe the "standard of review" for P.S.C. cases. *Id.* at 713. *See* D.C. Code 1973, § 11-722 ("review of orders and decision of the" P.S.C. not governed by D.C.A.P.A.).

all other administrative orders. This is demonstrated by the majority's reliance on cases which only interpret the very D.C.P.A. provisions which the en banc court viewed as inapplicable[4] to utility rate orders.[5] Therefore, whereas the en banc decision holds that "[o]ur review of a utility commission order is the narrowest judicial review in the field of administrative law,"[6] the majority opinion implicity holds that our review is no narrower in utility rate cases than in cases regarding the remainder of the field of administrative law. I believe that had the narrower scope of review later espoused by the en banc court been employed by the majority in this case, the majority could only have decided to affirm, as did the en banc court in the *Pepco* case.

The two opinions also differ on what the majority here terms as the agency's "burden . . . to explain its actions fully and clearly."[7] While a specific explanation of the agency's action, as reflected in its findings and conclusions, facilitates the appellate review process, the degree of explicitness demanded by the majority is much higher than that required by the en banc court in *Pepco*.

[4] *See* note 3 *supra*.

[5] *See Washington Public Interest Organization v. Public Service Commission*, *supra* at 77.

[6] *See Potomac Electric Power Co. v. Public Service Commission*, *supra*, slip op. at 7.

[7] *Washington Public Interest Organization v. Public Service Commission*, *supra* at 75.

I follow the majority opinion's organization by including this topic under scope of review, although I consider this to be technically improper. *Compare* D.C. Code 1973, § 43-705 *and* § 1-1510 (judicial review) *with* § 1-1509 (agency action). It is upon § 1-1509(e) that the majority relies in imposing this "burden to articulate" upon the Commission.

Two examples from the en banc opinion will suffice to demonstrate the disparate treatment accorded by the two bodies. For each example, the en banc court engaged in a three step process of (1) defining the party's contention, (2) noting that the Commission was cognizant of the contention and (3) stating that the contention was rejected. For example, on the issue of attrition, the en banc opinion states: (1) the company contended that the Commission failed "to adjust the test year figures for continuing attrition . . .", (2) the Commission's final order contains "comments that demonstrate its concern for the problem and the consideration it gave to the evidence of attrition," and (3) the Commission "by and large" did what it had done in the past; the order is affirmed.[8] *Potomac Electric Power Co. v. Public Service Commission, supra*, slip op. at 19-20. A second example of the en banc court's light touch regards the PJM interchange sales issue. The en banc court states: (1) the company contended that the Commission should adjust the test year amount of interchange sales because the amount of rate year (1975) sales would be considerably less than were sales during the test year (1974), (2) "the Commission was well aware of the point made by the company and did not ignore it" and (3) the Commission decided not to reduce the amount; the order is affirmed. *Id.*, slip op. at 24-28.

In neither of those instances did the en banc court exact from the Commission the step-by-step explanation that the majority here contends is required by the law. As to the attrition issue, the en banc court did not re-

[8] The en banc majority opinion in the *Pepco* case treated the attrition issue in a fashion which is quite imprecise. For a proper description of the subject matter, see the vacated division majority opinion in *Pepco v. P.S.C.*, D.C.App., 380 A.2d 126, 143-45 (1977).

quire the Commission to explain why the company's contention was rejected, but only to state that the Commission had considered the request and consciously rejected it.[9] On the interchange sales issue as well, the en banc court in *Pepco* did not require the Commission "to explain its actions fully and clearly," as the majority opinion in this case would mandate. 393 A.2d at 75. Despite the majority's position that "[a]bsent precise methodology as applied to the facts of the case, there is no way for a court to tell whether the Commission, however expert, has been arbitrary or unreasonable;"[10] the en banc court allows the Commission to withhold disclosure of its "methodology." The sole rationale advanced by the Commission for not reducing the 1974 interchange sales was that "1975 operating data, of which we may take official notice, indicates a resumption of a growth trend in [non-interchange] sales . . . and thus the two factors tend to offset each other to some degree." Slip op. at 27 (quoting from the Commission's order). There was no precise finding as to what the increase in non-interchange sales would be. Neither was there a finding of what decrease was expected in interchange sales. The specific data upon which the decision was based was not

[9] It is not enough to say that the reason was expressed in *Telephone Users Ass'n v. P.S.C.*, D.C.App., 304 A.2d 293, 298 (1973), because that decision did not address the issue. The issue there under consideration was the reasonableness of employing a weighted average rate base rather than a year-end rate base. The utility contended that the average rate base was unreasonably small in view of the anticipated attrition. In *Pepco*, the utility claimed that the *year-end* was unreasonably small and, therefore required adjustment, in view of the anticipated attrition. Thus, the issue before the Commission was not resolved by *Telephone Users*.

[10] *Washington Public Interest Organization v. P.S.C., supra* at 77.

disclosed, other than "1975 operating data." No reason was offered for the Commission's conclusion that the augmentation in non-interchange sales and the reduction in interchance sales would be similar in magnitude. Indeed, the Commission concedes that it never came to grips with these issues as indicated by the language of its order: "[the sales] *tend* to offset each other *to some degree.*" *Id.* (emphasis added). Clearly, had the en banc court employed the same rigorous "burden" as the majority used, the en banc court would have been constrained to remand to "[furnish] detailed findings of fact and conclusions of law," [11] to "[show] fully and clearly why it has taken the particular ratemaking action," [12] and to "[advance] affirmative, particularized reasons justifying its treatment" of interchange sales.[13] The en banc court's decision to affirm in *Pepco*, rather than to remand, exemplifies the fundamental inconsistency between the two opinions.

II. The Commission Carried Its Burden of Explanation

Even under the rigorous test established by the majority, the Commission carried its burden of demonstrating the rationale behind its decision to treat the gain on land dispositions as a below the line transaction. The majority's conclusion to remand is based on two errors. First, the majority either misperceived the issue in the case or unwarrantedly interjected a second issue. Second, the majority failed to comprehend the adequacy of the reasoning for treating the land transaction gains as below the line revenue. Had the majority exercised the

[11] *Washington Public Interest Organization v. P.S.C., supra* at 77.

[12] *Id.* at 75.

[13] *Id.* at 93.

same degree of diligence in seeking to understand the reason for the Commission's decision as it claimed the Commission should have exercised in explaining its rationale, it would not have remanded the record for clarification.

A. The Issue

The majority seems confused as to the issue before it. At the outset of the majority's opinion, it explained that the rates of return were not at issue:

> While the ultimate issue, upon judicial review, is the overall effect of the rate order, this is not to say that our review must encompass all aspects of that order. In the present case, for example, the overall *rate of return* is not directly at issue. None of the petitioners question the rate levels, as such, granted WGL and Pepco; all agree (or do not contend) that for the District of Columbia operations WGL is entitled to a 9.25% overall *rate of return* each year, while Pepco is entitled annually to 9.06% overall. [393 A.2d at 79 (emphasis added).]

It then stated that the return or revenue estimation was at issue:

> The narrow question, therefore, is whether a portion of each company's prescribed *return* should be deemed already paid by the realization of gain (or appreciation in value) on land no longer in service, entitling the customers to a short-term credit of some sort; or whether, instead, each company's *return* should be recoverable in full from charges to its customers. Thus, we are asked to limit our review to scrutiny of the Commission's expert judgment applied to

> but one of many elements of the ratemaking calculus. [393 A.2d at 79 (emphasis added).]

Following an eight page detour through the history and niceties of the Uniform System of Accounts, the majority abandons the issue and decides instead to resolve what is not at issue, *i.e.*, the propriety of the overall rate of return:

> The precise question is this: have petitioners made a "convincing showing" that the Commission's rate determinations are unreasonable, unjust, or discriminatory, D.C. Code 1973, § 43-301, because the decision in each case to allocate gains on particular dispositions of retired land exclusively to the investors is not rationally connected by "reliable, probative, and substantial evidence," D.C. Code 1977 Supp., § 1-1509(e), to the *rate of return* selected? Thus, we are asked to relate gains on particular land transactions to the Commission's determination of an *overall rate of return*—a complex inquiry. [393 A.2d at 85 (emphasis added and deleted) (footnote omitted).]

Having thus abandoned the issue for the "non-issue," the majority goes on to rule on the "non-issue," holding that it will remand because a relevant factor was possibly omitted from the calculation determining the overall rate of return:

> There is no indication in the record that the Commission, in determining the essential *rates of return* for WGL and Pepco, actually considered the impact of land transactions on the price of either company's common stock.
>
> • • • •

> Accordingly we hold that when a regulatory commission calculates and approves an *overall rate of return* (and consequent rate schedule) for utility operations, based on comparative stock prices, it must factor into its determination an analysis of the impact of nonutility transactions on the price of the company's stock . . . . [*Id.* at 91-93 (emphasis added).]

Thus, while passing through the dark forest of the Uniform System of Accounts, the majority lost its bearings by about 180 degrees. For clarity, I will first address the issue and then address the "non-issue," or the issue that the majority raised *sua sponte*.

B. The Analysis

The majority should have been content to address only the issue raised by the parties—whether the Commission reasonably excluded the gains on the land transactions from its calculations to determine "revenue." Simply stated, the issue is whether the Commission had a reasonable basis for ascribing the gains to the shareholders rather than the ratepayers. As the majority states, this court is bound by statutory and case law to affirm a Commission decision so long as it has a reasonable justification. 393 A.2d at 75. The Commission's decision was based on its accounting principles, and the majority opinion explains the justification for these principles:

> The justification for such accounting principles, with their impact on utility rates, is generally based on the proposition that the ratepayers, who have been charged for depreciation of plant facilities, should be repaid with the gains, if any, upon eventual sale of those fa-

> cilities. Because land is not depreciable, however, and the ratepayers accordingly have not been responsible for replenishing it, the gains, if any, on sales of retired land are left to the investor-owners. They are the ones, at least theoretically, who brought the land to the enterprise and, as a result, should benefit. [393 A.2d at 74.]

This justification is reasonable, and thus I am compelled to vote to affirm on the issue raised by the parties. *See* D.C. Code 1973, § 43-706. The petitioners contended that *Democratic Central Committee v. Washington Metropolitan Area Transit Comm'n*, 158 U.S.App.D.C. 107, 485 F.2d 886 (1973), *cert. denied*, 415 U.S. 935 (1974), mandates a different result. I agree with the majority that "*Democratic Central Committee* is distinguishable as more egregious on the facts," that this "contention misses the mark" and that, therefore, "the petitioners have not made the 'convincing showing' required to overturn a rate order." 393 A.2d at 88-89.

I turn now to the "non-issue." Not contenting itself to addressing the issue raised by the petitioners concerning the calculation of revenue, the majority decided to attack the "non-issue" concerning the calculation of the overall rate of return. In particular, the majority is concerned over whether the Commission considered "the impact of nonutility transactions on the price of the company's stock" [14] in calculating the overall rate of return. This issue should not have been raised, and once raised, it should have been differently resolved, both procedurally and substantively.

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[14] 393 A.2d at 93.

There is no doubt that in certain situations, this court should raise an issue *sua sponte*.[15] In other circumstances, this court *may* properly raise an issue of its own accord. The issue raised by the majority, however, fits neither bill. Furthermore, the procedure by which the issue was raised and decided was improper. The issues addressed in a rate matter are formulated early in the long and arduous process. The parties to the administrative proceeding question witnesses and present briefs addressing specified disputed areas. The Commission presents a proposed order to the parties for comments. By the comments, the Commission is informed of any issues that it has not addressed and of any issues it may have improperly resolved. In its final order, the Commission addresses the concerns raised by the comments. To further refine the issues and to allow the Commission an opportunity to prepare a clear explanation of its actions regarding points to be considered by this court, Congress required that a motion for reconsideration be filed as a prerequisite to raising an issue for judicial review. D.C. Code 1973, § 43-704 states:

> Any public utility or any other person or corporation affected by any final order or decision of the commission may . . . file with the commission an application in writing requesting a reconsideration of the matters involved, and *stating specifically the errors* claimed as grounds for such reconsideration. *No public utility or other person or corporation shall in any court urge or rely on any ground not so set forth in said application.* [Emphasis added.]

The briefs, record and argument before this court, then, address only the issues which endured each step of this

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[15] For example, see note 22, *infra*.

refinement and development process. Unfortunately, the majority raises an issue that was never addressed by any of the parties either here or in the administrative proceedings. No one ever questioned the role of nonutility transactions in formulating the overall rate of return. The stipulated records on appeal do not contain the administrative hearing testimony upon which the Commission relied in setting the relevant rates of return. In lieu of informing the parties that it was concerned as to an unraised issue and requesting supplemental briefs on the subject, accompanied by the relevant portions of the record, the majority chose to proceed blindly, holding that the impact of nonutility transactions must be factored into a determination of an overall rate of return. In its conclusion, it faulted the Commission for having developed an inadequate record and for not having explained its actions on the subject. I believe that the delay and the consequent prejudice spawned by the majority's actions can only result in injustice unaccompanied by any offsetting benefit. The Commission employed the identical method of calculating the overall rate of return here as it did in the en banc case, which was recently affirmed. The issue was not *sua sponte* raised there; it should not have been here.

Aside from the propriety and method of raising the "non-issue," I believe that it was erroneously resolved. The error primarily results from the majority's misunderstanding of the process used to determine the overall rate of return. The overall rate of return is the result of a weighted averaging of the rates of return of the different forms of investment. *See* 393 A.2d at 90. Contrary to the majority's understanding, the "discounted cash flow (DCF) analysis" is not used to compute the overall rate of return, but only the return on common stock. The DCF is a simple analysis based on the recog-

nition that investors receive a return on their investment through dividends ("yield") and eventually through selling the stock at a profit (appreciation or "growth").[16] The rates of return received through each means are added together to obtain the total return on common equity investment. Thus, if the price of a share of common stock rises from $100 to $104 over the course of a year (4% return) and if during the year the shareholder receives an $8 dividend (8% return), his total return would be 12%. The Commission explains this at page 30 of its order respecting WGL. The majority demonstrates its misunderstanding of this means of computing the total return on common equity by stating that the dividend yield is added to "an expected growth in *dividend*," 393 A.2d at 90, rather than referring to a growth in the value of the stock.

The most important misunderstanding, however, which provides the foundation for the majority's erroneous holding, is the mistaken belief that the Commission sets the rate of return on common equity at the figure "required to maintain each company's common stock price at or slightly above book value." 393 A.2d at 90. While this maintenance is a commendable long-term goal of any utility, it was not the short-term criterion used by the Commission here.[17] The Commission does "not endeavor

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[16] A minor financing cost adjustment to this formula has been omitted from the discussion for simplicity.

[17] A significant long-term deviation of market price from book value, whether the deviation be positive or negative, should raise a red flag for the ratemaking parties, including the Commission. The cause of the deviation should be ascertained and the responsible party should correct the situation, if any correction is needed. Many factors, other than the Commission's actions, influence the market-to-book ratio. *See, e.g., Re Chesapeake & Potomac Tel. Co.*, 4 P.U.R.4th 1, 33-34 (D.C. Pub. Ser. Comm'n 1974). *See also* note 18, *infra*.

to fix an equity price which will produce a particular market-to-book ratio." [18] In the Pepco order, for example, the Commission expressly "[recognized] that it is not our function, as a regulatory body, to determine the market price of Pepco's stock . . . ." In the WGL case, the Commission noted that the market-to-book ratio was about 0.55. If the Commission had acted in the manner in which the majority now states that it acted, the Commission would have set a *growth* rate of nearly 100% (in order to bring the ratio to 1.0 or slightly higher), whereas the Commission fixed a *total* rate of only 13.4%.[19] Therefore, while not patently erroneous, the basis of the majority's opinion is seen to be clearly erroneous when compared to the record. I turn now to the DCF method actually used by the Commission to fix the rate of return on common equity.

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[18] *Re Chesapeake & Potomac Tel. Co.*, 15 P.U.R.4th 302, 319 (D.C. Pub. Ser. Comm'n 1976), *citing Re Chesapeake & Potomac Tel. Co.*, 4 P.U.R.4th 33, 34 (D.C. Pub. Ser. Comm'n 1974). In the latter case, the Commission explained that market-to-book "ratios are a product of factors beyond the control of any regulatory commission. As a general matter, they are heavily influenced by the state of the capital market [and] by the returns fixed by other commissions" that regulate the same utility. 4 P.U.R.4th at 33-34.

[19] The Commission did, however, make a general reference to the market-to-book ratio in a small matter regarding the People's Counsel proposal to employ principally WGL data, rather than data on comparable companies, to establish the rate of return on common equity. The Commission rejected the proposal on two grounds. First, the risks facing gas distribution companies were regarded as stemming largely from the nature of the locale served. Under this criterion, the Commission stated, "The Company inevitably fared well." The main concern of investors had increasingly shifted, however, to gas supply considerations. Because in this regard WGL is on equal footing with other utilities which are located away

In both of the Commission's orders, it accepted the opinion of the staff expert witness regarding the rate to be accorded common stock. For example, in WGL, Mr. Glassman's analysis was accepted. He analyzed the past growth and yield statistics of 18 utilities that were comparable to WGL for DCF purposes. With minor adjustments, he summed the growth and yield components of his analysis, arriving at a recommendation of a 13.4% overall rate of return on common equity. This figure was then employed in a weighted averaging of the other forms of investment to produce the overall rate of return, which was applied to the rate base. So far as the orders reveal, the identical process was employed in the Pepco proceeding, of course employing companies comparable to Pepco. Therefore, contrary to the majority's position, whatever may be the future price of WGL's and Pepco's common stock had no place in the DCF analysis employed by the experts and adopted by the Commission. The "Commission's DCF analysis [does not] show [a] minimum essential price of common stock," as the majority suggests, but shows the rate of return received in the past by common shareholders of the subject utility and of the utilities similarly situated. The majority erroneously believes that the rate of return is

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from the production fields, a comparison of other comparatively situated utilities would be more meaningful than looking only to WGL's past. Second, the rates allowed in the past have resulted in the market price remaining significantly below book value for a long time, which generally does not happen if the requisite fair return is allowed. Therefore, what WGL has received in the past is not as reliable a guide as can be achieved by employing rate of return figures from comparable utilities. It was clearly not to the ratio, as the second of these two grounds, that the majority opinion repeatedly refers, because the majority does not question the correctness of the Commission's decision to reject the People's Counsel proposal.

"based on comparative stock prices," [20] where as it is actually based on comparative rates of return. Therefore the majority's primary concern, that the Commission may not have calculated "the impact of nonutility transactions on the price of the company's stock," fades into irrelevance and insignificance. It is unfortunate but telling that this irrelevant concern provides the sole basis for the majority's holding.

Numerous other deficiencies and inconsistencies in the majority's opinion could be addressed in order to demonstrate its fundamental misconception of the situation. The majority assumes that Pepco, for example, is comprised of only two portions: utility and nonutility. On this assumption it expresses its concern that "nonutility transactions might . . . [cause] a lower [or higher] overall rate of return than the Commission had thought essential [in order] to" "maintain the price of common stock at the appropriate level." 393 A.2d at 91. What the majority failed to recognize is that Pepco is regulated not only by "the Commission," but by Virginia, Maryland and federal commissions. It would be illogical to require the Commission to analyze "the impact of nonutility transactions" without also requiring an analysis of the impact of these other components of Pepco.[21] The

[20] 393 A.2d at 93.

[21] The difficulty attending the majority's position can perhaps best be seen in an attempt to set a rate for C & P Telephone Co., which is wholly owned by AT&T. The cost of C & P's capital is so intertwined with that of AT&T's capital that the Commission has never made a separate calculation of C & P's cost. *E.g., Re Chesapeake & Potomac Tel. Co., supra* at 308. Under the majority's holding, the Commission would be compelled to "factor into its [rate] determination an analysis of the impact of [non-C & P utility] transactions on the price of the company's stock . . . ." 393 A.2d at 93.

majority, however, does not require an analysis excluding these components.

In conclusion, if the Commission ever forsakes its current method of establishing a fair rate of return on common equity in favor of the method the majority erroneously believed the Commission employed, then the majority's holding might become applicable. By its terms, however, the majority's holding is applicable only when a commission's calculation is "based on comparative stock prices." 393 A.2d at 93. I would think that a simple supplement to the record—noting that "comparative stock prices" were not employed, that the rate fixed by the Commission was not that rate which "would be required to maintain each company's stock price at or slightly above book value," and that the amorphousness and unmanageability of attempting to calculate the impact of Virginia, Maryland, federal and nonutility transactions on the prospective price of each company's stock would undermine the reliability of any attempted calculation—would suffice to elicit an affirmance on the issue raised *sua sponte* by the majority.[22] The Court is unanimous in rejecting the petitioners' contention based on *Democratic Central Committee* and *Brandywine*.[23] 393 A.2d

[22] At page 32 of its Order No. 5833, the Commission appears to adjust Mr. Glassman's 13.4% result to 13.09% because he erroneously applied his flotation cost to both the growth and yield components, whereas the Commission applies it only to the yield component. Yet at page 37, the Commission purports to adopt the unadjusted figure. If this adoption was erroneous, the 9.25% overall, *see* order at 38, would appear to require reduction before the record is retransmitted for our further review.

[23] In an earlier decision, the Commission imposed, on WGL's ratepayers, certain losses resulting from the disposition of WGL's "Brandywine" property. The majority of the court

at 87 n.17, 89. I maintain that the *sua sponte* issue should not have been raised and further, that the scope of review employed by the majority has been eroded by the subsequent en banc *Pepco* opinion. Accordingly, I dissent.

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in this case held "that the Commission's Brandywine decision is irrelevant to this proceeding . . . ." 393 A.2d at 87 n.17.